SEVERAL COMMENTS ON HOW TO COMPROMISE PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Terence Floyd Cuff
Loeb & Loeb LLP
Los Angeles, California

© Copyright, 2014, Terence Floyd Cuff, All rights reserved.

Terry Cuff is of counsel at the Los Angeles office of Loeb & Loeb, LLP. He is interested in photography, VBA programming, and tennis. He claims no great proficiency in any of these endeavors, but he seeks to make up for lack of proficiency with boundless enthusiasm. Terry undertook his undergraduate work at the University of California, Santa Cruz, a long time ago. This work emphasized grooving with the redwoods and walking softly in the forest to avoid stepping on banana slugs. When he was younger and in better physical condition, from 1969 through 1974, Mr. Cuff served with the United States Marine Corps and the Marine Corps Reserve. Mr. Cuff learned to break things, to shoot things, to blow things up, and to shoot things down. Mr. Cuff seeks to apply these skills to his legal work.
## Table of Contents

1. Some Initial Thoughts. 15
2. Defending Drafting Errors and Omissions Claims. 18
3. The Draftsman’s Dilemma. 23
4. Ignore the Ethical and Other Legal Issues. 26
5. Do It Yourself By Yourself. 40
6. The Partnership Agreement Looks Wonderful, But I Cannot Understand It. 41
7. Just Start Drafting. 50
8. Rely on the Form Agreement. 51
9. Compromise Lock-in and Tax Protection Agreements. 53
10. Tax Issues With Which Simplicio Can Compromise the Partnership On Formation. 56
11. Get the Economics Wrong. 58
   a. Numerical Examples. 65
   b. Making Mistakes In Drafting Tiered Distribution Provisions. 71
   c. Cash Distribution Provisions That Merely Follow How Income is Allocated. 73
   d. Liquidating Distributions In Accordance With Capital Accounts. 74
   e. Determining Operating Cash Flow and Proceeds of Capital Events. 75
   f. Tax Distribution Provisions. 76
   g. Preferred Returns. 80
   h. Internal Rate Of Return Provisions. 85
   i. Other Common Issues Concerning Partnership Distributions. 91
   j. Squeeze-down Provisions on Default on Capital Contributions. 95
   k. Withholding Provisions. 97
13. Failure to Deal Adequately With Special Considerations of Service Partners.
   a. Canal Corporation.
   b. ILM 201324013.
15. Ignore Whether Purported Partner is a Partner, the Partnership Is a True Tax Partnership, or Property Contributions Will Be Respected.
16. Ignore Section 704(c) Issues.
18. Exchange Cooperation.
19. Target Allocations in General.
20. Section 704.
23. Basic Test of Economic Effect.
27. Value-equals-basis Presumption.
   a. Substantiality and Shifting Tax Consequences.
   b. Substantiality and Transitory Allocations.
29. Desire Not to Liquidate by Capital Accounts.
30. Partners’ Interests in the Partnership
32. Basic Test of Partners’ Interests in the Partnership. 188
33. Some Inquiries about Target Allocation Provisions and Partners’ Interests in the Partnership. 200
34. Drafting the Target Allocation Provision. 233
35. Drafting for Exculpatory Deductions. 244
   a. What Are Exculpatory Liabilities? 248
   b. Do Exculpatory Liabilities Produce Minimum Gain? 258
   c. Calculating Exculpatory Deductions if Exculpatory Liabilities Produce Nonrecourse Deductions. 264
   d. Calculating Exculpatory Deductions If Exculpatory Liabilities Do Not Produce Minimum Gain. 265
   e. Identifying Exculpatory Deductions. 266
   f. Allocating Exculpatory Liabilities. 268
   g. Allocating Exculpatory Deductions If Exculpatory Deductions Produce Minimum Gain. 270
   h. Allocating Exculpatory Deductions If Exculpatory Deductions Are Not Nonrecourse Deductions And Do Not Produce Minimum Gain. 271
36. Carelessly Draft Purposes Provision. 273
37. Carelessly Draft Terms for Cash Capital Contributions. 274
38. Carelessly Draft Terms for In-Kind Contributions of Property. 278
39. Inattention to Conversion of Up-REIT Units. 293
40. Borrowing from Partners and Emergency Loans 294
41. Bungle Management and Governance Provisions. 294
42. Partnership Meeting Provisions. 313
43. Fail to Provide Realistically for the Budget and Budget Contingencies. 315
44. Fail Adequately to Provide for Financial Reports. 316
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

45. Ignore Transfer Provisions. 318
46. Buy-Out Rights. 329
47. Ignore Other Laws – State and Otherwise. 336
49. Ignore Tax Audit Issues. 337
50. Dispute Resolution. 340
51. Indemnification. 349
52. Needs of Special Partners. 353
53. Winding Up and Liquidation 362
54. Securities Law Concerns. 363
55. General Drafting Considerations. 368
56. General Comments about Drafting Partnership Agreements. 370
   a. Drafting Principles. 370
   b. Whom Do I Represent? 372
   c. The Form Agreement. 373
   d. Your Team. 374
   e. Draft to Address the Litigation Threat. 376
   f. Good Writing. 376
57. Cash Capital Contributions. 377
58. In-kind Capital Contributions. 380
59. “Book” Income and “Book” Losses. 383
60. Definitions. 385
   a. Capital Account. 386
   b. Adjusted Capital Account. 390
   c. Adjusted Capital Account Deficit. 390
   d. Adjusted Capital Contribution. 391
   e. Distributable Cash. 392
   f. Nonrecourse Liability. 395
   g. Partnership Minimum Gain. 396
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

h. Partner Nonrecourse Debt. 396
i. Partner Nonrecourse Debt Minimum Gain. 397
j. Exculpatory Liability. 397
k. Exculpatory Liability Minimum Gain. 398
l. Net Profits and Net Losses. 398
m. Nonrecourse Deductions. 402
n. Partner Nonrecourse Deductions. 403
o. Exculpatory Deductions. 404

61. Cash Distributions. 405
   a. Preferred Return. 408
   b. Internal Rate of Return. 412
   c. Tax Distribution Provision. 428
   d. Partnership Withholding. 444
   e. State Law Distribution Limitations. 445
   f. Distributions of Property. 446
   g. Returns Preferred to Capital Distributions
to One Partner. 447

62. Allocations of Partnership Income and Losses. 457
   a. Net Losses. 458
   b. Net Profits. 460
   c. Tiered Allocations. 460
   d. “Layer Cake” Allocations. 463
   e. Target Allocations. 466
   f. Curative Allocations. 478
   g. Tax Allocations. 483
   h. Phantom Gain. 483
   i. Nonrecourse Liabilities. 484
   j. Nonrecourse Deductions. 486
   k. Partner Nonrecourse Deductions. 486
   l. Minimum Gain Chargeback. 487
   m. Partner Nonrecourse Debt Minimum
      Gain Chargeback. 488
   n. Exculpatory Liability Minimum
      Gain Chargeback. 489
   o. Qualified Income Offset. 490
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>p.</td>
<td>Chargebacks.</td>
</tr>
<tr>
<td>q.</td>
<td>Preferred Return.</td>
</tr>
<tr>
<td>r.</td>
<td>Internal Rate of Return.</td>
</tr>
<tr>
<td>s.</td>
<td>Tracking and Schedular Allocations.</td>
</tr>
<tr>
<td>t.</td>
<td>Recapture Amounts.</td>
</tr>
<tr>
<td>u.</td>
<td>Special Allocation of Imputed Interest.</td>
</tr>
<tr>
<td>v.</td>
<td>Order of Allocation and Distribution Provisions.</td>
</tr>
<tr>
<td>w.</td>
<td>Tiered Partnerships.</td>
</tr>
<tr>
<td>x.</td>
<td>Tax Treatment of Contributed Property.</td>
</tr>
<tr>
<td>y.</td>
<td>Varying Interests Rule.</td>
</tr>
<tr>
<td>z.</td>
<td>Excess Nonrecourse Liabilities.</td>
</tr>
<tr>
<td>63.</td>
<td>Consistency of Treatment.</td>
</tr>
<tr>
<td>64.</td>
<td>Guaranteed Payments.</td>
</tr>
<tr>
<td>65.</td>
<td>Tax Protection Agreement.</td>
</tr>
<tr>
<td>66.</td>
<td>Partnership Tax Audits.</td>
</tr>
<tr>
<td>67.</td>
<td>Partnership Income Tax Returns.</td>
</tr>
<tr>
<td>68.</td>
<td>Debt Maintenance Agreement.</td>
</tr>
<tr>
<td>69.</td>
<td>Guarantees.</td>
</tr>
<tr>
<td>70.</td>
<td>Organizational Expenses.</td>
</tr>
<tr>
<td>71.</td>
<td>Member Loans.</td>
</tr>
<tr>
<td>72.</td>
<td>Service Partners.</td>
</tr>
<tr>
<td>73.</td>
<td>Series Entities.</td>
</tr>
<tr>
<td>74.</td>
<td>Name.</td>
</tr>
<tr>
<td>75.</td>
<td>Recording or Filing.</td>
</tr>
<tr>
<td>76.</td>
<td>Jurisdiction of Organization.</td>
</tr>
<tr>
<td>77.</td>
<td>Intent to Form a Partnership.</td>
</tr>
<tr>
<td>78.</td>
<td>Limited Liability.</td>
</tr>
<tr>
<td>79.</td>
<td>Term.</td>
</tr>
<tr>
<td>80.</td>
<td>Qualification.</td>
</tr>
</tbody>
</table>
### Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>81.</td>
<td>Purposes.</td>
<td>586</td>
</tr>
<tr>
<td>82.</td>
<td>Powers.</td>
<td>589</td>
</tr>
<tr>
<td>83.</td>
<td>Temporary Investments.</td>
<td>594</td>
</tr>
<tr>
<td>84.</td>
<td>Power of Attorney.</td>
<td>594</td>
</tr>
<tr>
<td>85.</td>
<td>Priorities of Partners.</td>
<td>596</td>
</tr>
<tr>
<td>86.</td>
<td>Interest on Capital Contributions.</td>
<td>597</td>
</tr>
<tr>
<td>87.</td>
<td>Elections.</td>
<td>597</td>
</tr>
<tr>
<td>88.</td>
<td>Tax Notices.</td>
<td>599</td>
</tr>
<tr>
<td>89.</td>
<td>Admission of Partners.</td>
<td>600</td>
</tr>
<tr>
<td>90.</td>
<td>Withdrawal of Partners.</td>
<td>601</td>
</tr>
<tr>
<td>91.</td>
<td>Partner Meetings.</td>
<td>602</td>
</tr>
<tr>
<td>92.</td>
<td>Management.</td>
<td>606</td>
</tr>
<tr>
<td>93.</td>
<td>Expenses.</td>
<td>644</td>
</tr>
<tr>
<td>94.</td>
<td>Rights of Non-Managing Partners.</td>
<td>645</td>
</tr>
<tr>
<td>95.</td>
<td>Transfer of Partnership Interests.</td>
<td>645</td>
</tr>
<tr>
<td>96.</td>
<td>Liquidation and Dissolution.</td>
<td>660</td>
</tr>
<tr>
<td>97.</td>
<td>Put-Call Provision.</td>
<td>671</td>
</tr>
<tr>
<td>98.</td>
<td>Sale of the Property – Exchange Option.</td>
<td>676</td>
</tr>
<tr>
<td>99.</td>
<td>Registered Office and Agent.</td>
<td>679</td>
</tr>
<tr>
<td>100.</td>
<td>Fictitious Business Certificate.</td>
<td>680</td>
</tr>
<tr>
<td>101.</td>
<td>Business Qualification.</td>
<td>681</td>
</tr>
<tr>
<td>102.</td>
<td>Business Transactions with the Partnership.</td>
<td>681</td>
</tr>
<tr>
<td>103.</td>
<td>Standard of Care.</td>
<td>682</td>
</tr>
<tr>
<td>104.</td>
<td>Standard of Discretion.</td>
<td>682</td>
</tr>
<tr>
<td>105.</td>
<td>Fiduciary Duties.</td>
<td>684</td>
</tr>
<tr>
<td>106.</td>
<td>Indemnification.</td>
<td>691</td>
</tr>
<tr>
<td>107.</td>
<td>Contracts with Affiliates.</td>
<td>695</td>
</tr>
</tbody>
</table>
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>108.</td>
<td>Annual Budget.</td>
</tr>
<tr>
<td>110.</td>
<td>Reports.</td>
</tr>
<tr>
<td>111.</td>
<td>Right to Information from Partners.</td>
</tr>
<tr>
<td>112.</td>
<td>Partner’s Right to Partnership Information.</td>
</tr>
<tr>
<td>114.</td>
<td>Voting and Amendments.</td>
</tr>
<tr>
<td>115.</td>
<td>Meetings.</td>
</tr>
<tr>
<td>116.</td>
<td>Written Consent.</td>
</tr>
<tr>
<td>117.</td>
<td>Legend and Investment Representations.</td>
</tr>
<tr>
<td>118.</td>
<td>Certification of Interests.</td>
</tr>
<tr>
<td>119.</td>
<td>Confidentiality.</td>
</tr>
<tr>
<td>120.</td>
<td>Non-Competition.</td>
</tr>
<tr>
<td>121.</td>
<td>Business Opportunities.</td>
</tr>
<tr>
<td>122.</td>
<td>Accounting Method.</td>
</tr>
<tr>
<td>123.</td>
<td>Taxable Year.</td>
</tr>
<tr>
<td>125.</td>
<td>Bank Accounts.</td>
</tr>
<tr>
<td>126.</td>
<td>Offset.</td>
</tr>
<tr>
<td>127.</td>
<td>Remedies for Breach.</td>
</tr>
<tr>
<td>128.</td>
<td>Expulsion.</td>
</tr>
<tr>
<td>129.</td>
<td>Time Devoted to Partnership Affairs.</td>
</tr>
<tr>
<td>130.</td>
<td>Arbitration.</td>
</tr>
<tr>
<td>131.</td>
<td>Conversion to a Corporation.</td>
</tr>
<tr>
<td>a.</td>
<td>Basic Rules.</td>
</tr>
<tr>
<td>b.</td>
<td>Liabilities.</td>
</tr>
</tbody>
</table>


SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

c. Promissory Notes. 761
d. Revaluation of Partnership Assets. 764
  i) General Requirements. 764
  ii) When Can You Revalue Capital Accounts? 767
  iii) Revaluation on Admission of a Service Partner. 769
  iv) How is Revaluation Surplus or Loss Allocated? 774
  v) Drafting Allocations after Capital Account Revaluations. 778
  vi) Noncompensatory Partnership Options. 779
  vii) Securities Partnerships. 785
  viii) Tax Items Associated with Revalued Assets. 785
  ix) Determination of Values for Revaluations. 785

e. “Book”-Tax Disparities. 787

133. Nonrecourse Deductions. 788
    a. Nonrecourse Liability. 790
    b. 10 Percent or Less Partner Lender. 792
    c. Partner Guaranteed Loans. 796
    d. Nonrecourse Deductions. 797
    e. Nonrecourse Deduction Allocation Rule. 801
    f. Revaluation of Partnership Assets. 811

134. Minimum Gain Chargeback. 811
135. Partner Nonrecourse Deductions. 820
136. Partner Nonrecourse Debt Minimum Gain Chargeback. 825
137. Exculpatory Deductions. 826
138. Section 704(c)(1)(A) and “Book” Income. 832
139. Traditional Method under Section 704(c)(1)(A). 836
    a. Built-in Gain and Loss. 838
    b. Fair Market Value. 841
    c. Property-by-Property Application. 849
    d. Limited to True Contributions. 849
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

e. General Principles. 849
g. Cost Recovery Deductions: Overall Net “Book” Income. 853
h. Cost Recovery Deductions: Contributions of Multiple Properties. 857
i. Cost Recovery Deductions: Ceiling Rule. 863
j. Gain on Sale: Tax Gain but no “Book” Gain. 866
k. Gain on Sale: Tax Gain and “Book” Gain. 867
l. Partnerships Not Using Capital Accounts. 871
m. Unreasonable Use of Traditional Method. 874
n. Partnership Termination. 879
o. Multiple Methods. 880
p. Transfer of Partnership Interest. 881
q. Reverse Section 704(c) Allocations. 883
r. Nonrecognition Exchanges of Section 704(c) Property. 883
s. Installment Sale. 886
t. Option as Section 704(c) Property. 887
u. Long-term Contracts Method. 888
v. Capitalized Amounts and Contingent Liabilities. 891
w. Tiered partnerships. 892
x. Aggregation 893

140. Substantial Economic Effect. 894

a. Economic Effect. 898
b. Filters of Economic Effect. 899
c. Capital Account Maintenance. 900
d. Liquidation in Accordance with Capital Accounts. 900
e. Deficit Capital Account Restoration. 907
f. Other Conventions. 910
g. Alternate Test for Economic Effect. 911
h. Limitations on Loss Allocations. 916
i. Capital Account Maintenance and Liquidation. 917
j. Adjustments to Capital Account. 918
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

i) Depletion. 918
ii) Section 704(e)(2), Section 706(d), and Section 751. 920
iii) Section 704(e)(2) Adjustments. 920
iv) Section 706 Adjustments. 923
v) Section 751(b) Adjustments. 924
vi) Distributions over Positive Capital Account Adjustments. 925
vii) Qualified Income Offset. 930

k. Partial Economic Effect. 934
l. Economic Effect Equivalence. 934

141. Partners’ Interests in the Partnership. 935

142. Substantiality. 942
   a. Overview of the Problem. 943
   b. Economic Effect. 944
   c. Overview of Revised Regulations on “Substantiality.” 945
   d. Basic Filter of “Substantiality.” 946
   e. After-Tax Filter of “Substantiality.” 946
   f. Look-through Entities. 948
   g. Regulated Investment Companies and Real Estate Investment Trusts. 953
   h. Consolidated Groups. 956
   i. Reallocation Under Other Provisions. 957
   j. Baseline. 958
   k. Basic Filter of “Substantiality.” 959
   l. “Value Equals Basis” Rule. 959
   m. Gain Chargebacks. 964
   n. Fill-up Allocations. 965
   o. After-Tax Filter of “Substantiality.” 973
   p. Present Values. 976
   q. After-Tax Effects. 976
   r. Comparison to “Partners’ Interests in the Partnership.” 976
   s. Illusion of Computational Regime. 979
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

t. After-Tax Effects. 979
u. Discount Rate. 980
v. Projections. 980
w. Baseline for Comparison. 983
x. Per Capita Presumption. 985
y. Pass-Through Entities. 986
z. Shifting tax consequences. 989
  i) Capital Account Test. 992
  ii) Tax Consequences Test. 993
  iii) Presumption Concerning Shifting Tax Consequences. 995
aa. Transitory Allocations. 996
bb. Five-Year Presumption. 997
143. Special Partner Considerations. 999
144. Section 724: Contributions of Receivables and Inventory. 1003
145. Contributed Payables. 1004
146. Intangibles. 1005
147. Section 1.752-7 Liabilities. 1011
148. Investment Partnerships. 1021
149. Qualified Organizations and the Fractions Rule. 1026
  a. Unrelated Business Taxable Income. 1027
  b. Acquisition Indebtedness. 1027
  c. Qualified Organizations. 1029
d. Fractions Rule. 1030
  i) Section 704(c) Items Are Excluded. 1031
  ii) Prospective Satisfaction of Fractions Rule. 1031
  iii) Changes to Partnership Agreement. 1032
  iv) Fractions Rule Percentage. 1032
  v) Overall Partnership Income and Overall Partnership Loss. 1033
  vi) Reasonable Guaranteed Payments and Reasonable Preferred Returns. 1034
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

vii) Chargeback Allocations. 1037
viii) Exclusion of Reasonable Partner-Specific Items of Deduction or Loss. 1041
ix) Exclusion of Unlikely Losses and Deductions. 1041
x) Provisions Preventing Deficit Capital Account Balances. 1043
xi) Exception for partner nonrecourse deductions 1044
xii) Changes in Partnership Allocations Arising From a Change in the Partners’ Interests. 1044
xiii) De minimis Interest Rule. 1045
xiv) De minimis Allocations. 1045
xv) Anti-Abuse Rule. 1045

150. Section 168(h)(6). 1046
151. Section 470. 1046
152. Disguised Sale Provisions. 1054
   a. Covenants. 1056
   b. Theory. 1056
   c. Base Test of Disguised Sale under Section 707. 1057
   d. Two-Year Presumptions. 1058
   e. Transfers of Encumbered Property to a Partnership. 1059
   f. Distribution of Refinancing Proceeds. 1061
   g. Reimbursement of Preformation Expenses. 1062
   h. Reasonable Guaranteed Payments and Preferred Returns. 1063
   i. Operating Cash Flow Distributions. 1067
   j. Disguised Sale of Partnership Interests. 1070

153. Conclusion. 1073
This is a story about two partnership agreement\(^1\) draftsmen.

The innocent draftsman is Simplicio.

The careful draftsman is Salviati.

Simplicio does all that he can to draft his partnership agreements at minimum cost. He relies heavily on forms. Simplicio is religious. He looks to the angels to protect him. He looks to his insurance company to rescue him from his drafting errors and omissions. The angels and his insurance company thus far have kept Simplicio’s mistakes from having a fatal effect on his practice.

Salviati drafts more slowly and more carefully. Salviati does what he can to avoid making drafting errors.\(^2\) Salviati’s work is more expensive than Simplicio’s work – at least, during the drafting stage.

This also is a story of the accountant. The accountant usually remains in the background. The accountant often is the key to an effective partnership agreement that carries out the economic views of the parties. Draftsmen ideally can work with the partnership accountants during the partnership agreement drafting process.

### 1. Some Initial Thoughts.

Partnership agreements provide many opportunities for Simplicio to produce compromised work and to damage his clients. Simplicio will take advantage of these practically boundless opportunities. Simplicio prepares infirm partnership agreements on a routine basis.

The partnership agreement gives Salviati the opportunity to tailor rules for the future of the partnership. His drafting is slow, careful, and deliberate. Salviati works with the partnership accountants in order to ensure that the partnership economics as reflected in the partnership agreement accord with his client’s concept of the business deal.

---

\(^1\) This Article uses the term “partnership” to include general partnerships, limited partnerships, limited liability partnerships, limited liability companies, joint ventures and other entities subject to tax under Subchapter K of the Internal Revenue Code. This Article uses the term “partnership agreement” to include the organizational documents for each of these entities.

\(^2\) See Galileo Galilei, *Dialogo dei due massimi sistemi del mondo* (Florence, 1632) for further material on Simplicio and Salviati.
Drafting partnership agreements balances the immediate gratification of producing partnership agreements quickly, economically, and efficiently against the long-term satisfaction of producing partnership agreements that will survive the many challenges of the life of the partnership. The partnership can live with fewer rules designed up-front. The partnership can address issues when these issues appear in partnership operations. This technique, Simplicio’s approach, makes drafting the partnership agreement considerably less expensive, quicker and less troublesome. The partnership defers disputes and disagreements. The partnership may rely on default provisions under state law. Future controversies and disagreements, however, typically are more difficult and more expensive to resolve in an orderly manner if resolution is deferred until the troubles occur.

Simplicio can draft a compromised partnership agreement with inadequate provisions concerning capital contributions, distributions, allocations, management, meetings, budgets, business plans, development plans, audits, reports, tax returns, banking, transfers, dispute resolution, securities, put/calls and other buyout rights, liquidation, rights to business opportunities after liquidation, rights to client relationships after liquidation, treatment of receivables after liquidation, amendment, fiduciary duties, notices, transfers, and other provisions. Each provision offers new opportunities for Simplicio to compromise the partnership agreement.

No partnership agreement is perfect. No partnership agreement addresses all potential situations. No partnership agreement works for all types of business. The question for the draftsman and the partners is: to what extent is it economic to address future issues up-front before disputes have occurred (and when agreement often is easier to obtain), or should these issues be addressed when disputes occur (and parties may have greater stakes in the resolution)? The draftsman and the partners also should consider: to what extent is an “off the shelf” partnership agreement appropriate to save cost or to what extent is customization appropriate?

A partnership agreement often manifests the draftsman’s and the partners’ dreams. The partnership agreement projects considerations that occur to the draftsman and the partners at signing well into the future of the partnership.

Simplicio has little imagination and little foresight. He dreams in black and white. His partnership agreements reflect his limited imagination. These partnership agreements tend to provide for a comparatively rigid, one-track structure from formation through liquidation of the partnership. His partnership agreements usually are comparatively inexpensive. He customizes his work by inserting the partnership name and address, correct parties and percentage interests in a standard form.

Salviati dreams in Technicolor. Salviati has colorful, vivid, textured dreams. Salviati anticipates a broad variety of events that may later confront the
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

partnership. His partnership agreements are more detailed, more flexible, and more expensive. Salviati’s partnership agreements anticipate many of the problems that his partnerships can encounter in the future. Salviati’s partnership agreement are customized to the parties and the particular transaction.

Future difficulties usually are more easily resolved (and parties tend to be friendlier), as a general matter, while the partnership agreement is being drafted rather than on the spot when the partnership confronts an immediate problem that was not anticipated at the drafting stage.

Savings in drafting the partnership agreement can have an almost magical multiplier effect. Simplicio can save his clients thousands of dollars at the drafting stage by not wasting his time reviewing his form partnership agreement, by drafting quickly, by proofing quickly, by minimizing or avoiding customization, by failing to consider future problems in the life of the partnership, and by failing to work with the partnership accountants. This often leads to a happier client at the time of closing of the partnership.

Dollars saved at the drafting stage can have a dramatic multiplier effect. Dollars saved at the drafting stage can translate into many thousands, millions, tens of millions or even hundreds of millions of dollars in damage further down the line in the partnership’s life. Some discover that this is false economy.3

The range of matters that can challenge a partnership during its life is infinite. Partners’ willingness to consider, to plan for, and to pay for drafting to deal with, these issues is finite. Every partnership agreement is a compromise between time, patience, money, and the need to consider reasonably expected events in the partnership’s future.

The client who receives a freshly drafted and signed partnership agreement typically is overjoyed to be done with the drafting process. He typically ignores that the new partnership agreement may be a Pandora’s box of problems for the future.

This Article discusses what can happen when Simplicio decides to draft the partnership agreement more quickly and less expensively. Transactional attorneys often draft compromised partnership agreements, limited partnership agree-

3 Readers are cautioned that errors in a partnership agreement do not necessarily constitute malpractice. Malpractice will depend on prevailing standards among draftsmen of partnership agreements in the relevant community. There are many areas of drafting partnership agreements where the law is unsettled and accepted practice is not necessarily clear.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ments, and limited liability company agreements. This Article discusses what can happen when Simplicio fails to consider the complexity and subtlety of a partnership or LLC agreement. This Article is a brief “how to” guide.

This Article discusses miscellaneous common techniques for drafting compromised partnership agreements. The techniques for drafting compromised partnership agreements that this Article discusses by no means are exhaustive of the popular techniques. Partnership agreements provide Simplicio with abundant opportunities to make mistakes and to draft compromised partnership agreements. Some readers may find additional ways to draft compromised partnership agreements on their own. Simplicio can add some new ways in which to compromise a partnership agreement through poor drafting.

This Article does not tell you how to draft a partnership agreement. This Article does discuss some issues you should consider in drafting a partnership agreement.

2. Defending Drafting Errors and Omissions Claims.

The draftsman should overcome his own arrogance. The typical draftsman may make drafting errors. The key is to ensure that these drafting errors are minor and not critical. A surprising proportion of partnership agreements have economic errors – large or small – or other significant errors. Perhaps most partnership agreements with economic schemes more complex than straight percentage allocation and distribution provisions have some economic or tax errors – large or small. The author’s experience is that a surprisingly high percentage of the partnership agreements drafted by major law firms have material drafting errors.

4 This Article uses the terminology “compromise” generically and in a lay sense rather than as a technical legal concept. In this sense, an immaterial typographical error usually might a “small compromise” or perhaps an “error,” while a major economic error in a partnership agreement might be considered a “major compromise.” This Article contains a number of recommendations and often uses the verb “should” or “will.” Readers should take these recommendations as suggestions. These suggestions do not constitute legal advice. Giving legal advice would require specific knowledge of the specific factual situation. No one should infer from the use of the verb “should” that the author suggests that these recommendations establish (or necessarily reflect) the prevailing standard of care – or that these recommendations necessarily reflect generally accepted best practices. The author leaves it to the judgment of every draftsman to determine his own drafting and to apply the appropriate standard of care. The author hopes that this Article will contribute to help the draftsman with his drafting task.
More careful drafting, proofing, and review could have avoided many of these drafting errors, but might have led to increased drafting cost. Many of these economic errors might have been identified by proper modeling by the accountants and review by clients, other attorneys, paralegals, secretaries, and others participating in the deal. Better proofing could have uncovered other errors. The poor quality of many partnership agreements typically reflects the efforts of attorneys to be more cost efficient and more responsive to the timing and cost demands of their clients. Many attorneys are complacent about producing flawed partnership agreements.

Defending an errors and omissions lawsuit over partnership agreement drafting errors is not nearly so much fun as Simplicio may imagine. The cost of defense can be more than trivial. Simplicio may hear whispering in the hallways of his office behind his back.

An able malpractice attorney –

- May spend days in deposition examining Simplicio.
- May review all of Simplicio related email traffic.
- May examine Simplicio about all of his client meetings and all of his telephone calls during negotiations.
- May examine Simplicio about all of his notes in files.
- May examine Simplicio on all of the provisions of the partnership agreement.
- May examine Simplicio on every –
  - Incorrect cross-reference,
  - Spelling error,
  - Grammatical error,
  - Unfilled blank,
  - Missing exhibit,
  - Unsigned signature block,
  - Grammatical error, and
  - More serious drafting error.
- May examine Simplicio on every interim draft partnership agreement.
- May examine Simplicio on all of his conversations with colleagues during the drafting process.
• May force Simplicio, at trial during cross-examination, to defend his work.

Simplicio later may find himself waiting through painful days as the jury deliberates.

Some of the best law firms in the country have drafted partnership agreements that have fallen short, with economic provisions that parties have disputed in court. No law firm is so good or so prestigious that clients or the courts automatically accept its drafting of partnership agreements as correct. A presumption of competent drafting should not attach to a partnership drafted by any law firm. Disputes concerning ambiguous or defective partnership agreements help to fund the college educations of the children of litigators.

Large, prestigious law firms may have the opportunity to make much larger and more notorious drafting mistakes than small, local law firms. A junior associate, a sleep-deprived, overworked partner, or a senior partner with declining drafting skills might draft language that can create millions or tens of millions of dollars of economic exposure to his law firm. Even an experienced, talented draftsman at the peak of his ability can make costly drafting errors.

A large errors and omissions case for drafting errors in a partnership agreement can threaten the solvency and continued existence of even a large law firm. This is not a purely theoretical risk.

The threat of an action for errors and omission is a risk that Salviati considers throughout the drafting process for every partnership agreement. Salviati is a little scared whenever he drafts a new partnership agreement. Simplicio drafts away unconcerned. He believes in angels who will protect him, and his law firm has good insurance.

One of the largest and more prestigious New York law firms drafted a tax distribution provision in a partnership agreement that, its client later asserted, distorted partnership economics by hundreds of millions of dollars through tax distributions to one of the partners. The law firm’s client lost when it disputed at trial how the partnership agreement worked. The partners settled the matter confidentially after trial.

Another law firm drafted a provision for liquidating distributions to follow set economic tiers not referencing capital accounts. The partnership agreement contained a deficit restoration provision. This partnership agreement was a template for a series of real similar estate transactions. The partnership agreement resulted in a dispute involving hundreds of millions of dollars of value.

A large institutional real estate investor agreed to fund any deficit balance in its capital account in order for the tax law to respect tax allocations. the real estate investor discovered, at liquidation of the limited partnership, that its capital
account had a deficit balance of many millions of dollars. The real estate investor was not pleased. It argued that it had agreed to the capital account deficit restoration obligation only as tax boilerplate.

A limited liability company amended its operating agreement to make the buy-out provision for several managing members less favorable to these managing members. In arbitration, these members successfully asserted that the amendment was invalid. The amendment constituted a forfeiture of compensation in violation of state labor laws. The arbitration resulted in a judgment of tens of millions of dollars in favor of the former managers.

A real estate development partnership removed a partner as manager and diluted his partnership interest because of his failure to make additional capital contributions. The public press attacked the money partner for seeking to defraud the old manager. The resulting dispute over alleged fiduciary breaches by the new managing partner and terms of dilution of the former manager was in trial for more than a year. The result was a large monetary judgment in favor of the money partner.

Another partnership agreement provided for the buy-out of managing partners as they withdrew from the partnership. The parties disputed whether the partnership should purchase this interest at unadjusted capital account value or at fair market value (and then whether fair market value should consider valuation discounts). The dispute ended up with tens of millions of dollars of claims and extensive litigation.

A partner purchased the mortgage loan of his partnership at a severe discount. The partnership and the other partners sued the partner for appropriation of a partnership business opportunity.

A partnership sought to buy out transferees of a partnership at a severe discount. The partnership stopped making distributions of operating cash to partners, so that the transferees, who had tax liabilities from the partnership income far in excess of their distributions, would be more inclined to sell out at a favorable price.

A restaurant partnership allocated all income following cash distributions. Limited partners, who invested roughly $10 million, made all capital investments. The partnership distributed all cash first to limited partners to return their capital investments, plus a percentage return, and then distributed under percentage interests. The partnership agreement liquidated in accordance with capital accounts. The partnership sold its restaurant after the partnership had just returned capital to the limited partners. This resulted in interesting discussions between the general partners and limited partners when the partners realized that practically all cash from liquidation would go to the limited partners on account on the income allo-
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

cation to the limited partners while their capital contributions were being returned to them.

A real estate investment trust sought to merge with another corporation. The real estate investment trust was a partner in a partnership that owned a celebrated hotel. A court enjoined the merger for violation of the antitransfer provision in the partnership agreement.

A partnership entered into a tax protection agreement with a contributing partner. The partnership agreed to indemnify the contributing partner on its tax from Section 704(c) gain if the partnership sold the contributed property in a taxable sale. The partnership later merged with another partnership and forced out the contributing partner for a cash payment. The contributing partner sought indemnification under the tax protection agreement. The partnership asserted in litigation that the indemnification agreement did not apply. The tax protection agreement applied only to gain on a sale of the contributed property, not on a cash-out merger.

A law firm partnership rented all of its personal property from a leasing company. The partnership later learned that the three name partners owned the leasing company. The dispute ended up in nasty litigation between a group of departing partners and the partnership.

A law firm partnership had a favorable lease with its landlord. The landlord offered to make a substantial cash payment to the partnership in return for renegotiating the lease to current fair market value (or perhaps even above market rents). Senior partners approved the prepayment. Less senior partners later argued that by the distribution to older generation partners prejudiced the interests of less senior partners. Younger partners were left with the higher lease payments. The acrimony led to disputes that caused the law firm partnership to dissolve.

A law firm partnership heavily and regularly leveraged its accounts receivables and distributed the proceeds to partners on a current basis. The partnership admitted new partners without the new partners signing the partnership agreement. The law firm partnership provided little information to most of the partners. Most partners were unaware that the partnership was distributing large amounts of borrowed money. Many partners thought that the business of the partnership was booming as the partnership approached bankruptcy. The result was a series of nasty disputes between partners and the partnership and between the partnership and its lenders. The law firm partnership dissolved in a large bankruptcy.

A prominent estate planner drafted a family partnership agreement. A partnership interest was later transferred outside of the family. The partnership sued the estate planner for tens of millions of dollars of alleged damages for hav-
ing failed to draft restrictions that would keep ownership of the partnership interest within the family. The matter settled quietly.

A law firm partnership that failed to admit a female associate to partnership found itself before the United States Supreme Court defending its decision.

One of the dirty little secrets of partnership practice is that clients file claims against law firms for negligent practice. These claims often are justified. These can be claims for large dollar amounts – sometimes staggering amounts. Clients – or former clients – can file these claims against law firms big and small, practitioners prominent and obscure. Law firms in other cases cannot collect their fees or have to make substantial settlements with clients over negligent drafting of partnership agreements.

3. The Draftsman’s Dilemma.

Legal work typically is expensive. Legal work typically more expensive than clients would prefer to pay for. Clients want top quality legal work at “reasonable” prices. Clients want high quality partnership agreements at “affordable” prices. There typically is tension between the two considerations.

Efforts that can improve the quality of partnership agreements often can increase the drafting cost. Clients typically fail to understand all of the challenges that a draftsman can face in drafting a partnership agreement for a complicated deal.

Cost of legal work typically reflects two considerations – billing rates and time spent. Billing rates typically reflect experience and reputation both of the practitioner and the firm. Billing rate per hour is an imperfect, but common, surrogate for a better metric of quality. More experienced and more specialized attorneys generally have higher billing rates.⁵

Large and medium-sized law firms typically focus on high quality, custom work. Their traditional focus has been much more on quality and speed than low price. Large and medium-size law firm work typically is expensive. Large and moderate law firm work, however, is not always reliable.

Small law firms more typically work on smaller deals. Smaller law firms often represent clients with greater cost sensitivity. Their work can be fine for the businesses they represent. Most small firms usually are cost conscious on account

⁵ High billing rates are not a guarantee of quality. The practitioner excellent for one task is not necessarily excellent for all tasks.
of their clients’ needs and demands. Even short partnership agreements can have challenging economic, tax, and other issues.

Clients often are staggered by the cost of high quality (or even low quality) legal work. Clients can seek lower billing rates by insisting that work migrate to low-billing-rate attorneys. These attorneys generally are less experienced attorneys more recently graduated from law school. Drafting work may migrate to paralegals. Clients can seek law firms with lower billing rate schedules. These clients may end up with less specialized and perhaps less experienced practitioners. Clients can take a more proactive role in the drafting process, by helping with modeling and proofing tasks or even drafting tasks.

Clients can pressure their attorneys to spend less time on drafting and reviewing a partnership agreement. Attorneys often are willing to accommodate these requests. Attorneys can accommodate clients through increased standardization and the increased use of standardized forms. Attorneys may accommodate demands for controlling their fees by decreasing the time that they spend reviewing, verifying, and proofing their work.

Better review, verification, proofing, and modeling should detect a high percentage of the faults with partnership agreements. The draftsman easily compromises review, verification, proofing, and modeling as he seeks greater drafting “efficiency.” Review, verification, proofing, and modeling increase costs. Their benefit often is not immediately apparent. The failure of adequate review, verification, proofing, and modeling is usually not detected until later. Even many of the most prestigious law firms may compromise the production of partnership agreements to achieve “efficiency” and more “reasonable” cost or greater drafting speed.

Economic deals are not so standardized that a simple generic partnership agreement or set of economic provisions will accommodate all economic deals. Different clients have different needs. Different clients have different price sensitivities. Different transactions have different needs. Different negotiations have different needs. Drafting partnership agreements can require subtle judgment and experience. The draftsman requires judgment and experience in the context of the transaction and the client.

Form partnership agreements usually are an important part of the drafting process; however, drafting high quality partnership agreements usually is much more than filling in blanks in a form. Drafting partnership agreements usually is not simply fill-in-the-blanks work. The draftsman should assess both his client’s needs and the results that he can expect to achieve in negotiation. The draftsman should assess what his client is willing to pay for.

Beyond this, all forms represent compromises and judgments. Forms often contain errors – sometimes errors of considerable economic gravity. Additionally,
uncertainties and subtleties can exist about the corporate law of partnerships and the tax law of partnerships.

The tax law of partnerships is uncertain. The state of the art of partnership taxation (or perhaps the prejudice of the moment) can change quickly. The draftsman should be sensitive to changes in accepted standards. Forms need to be changed, updated, and verified frequently. Target allocation provisions are an uncertain area of the tax law. The tax world has not embraced a standard school solution.

Even experienced draftsmen often have difficulty drafting partnership agreements that properly reflect the economics mandated by their clients. Small changes in the economics of the deal from the deal contemplated in the form agreement can create substantial drafting challenges, particularly as the changes ripple through all of the economic provisions of the partnership agreement. This should require substantial testing of the economic terms of the partnership agreement with realistic numbers. Even experienced draftsmen may fail fully to appreciate mathematical subtleties of their clients’ deals.

Clients themselves often fail adequately to apprehend subtleties of the economic deal. Both clients and draftsmen often fail adequately to understand the mathematics of economically complex deals. Use of internal rate of return hurdles, for example, can exceed the mathematical sophistication of the typical draftsman – and the typical client.

As a slight overgeneralization, the legal community can be divided into those who admit that they do not understand the mathematics of internal rate of return and those who assert that they understand the mathematics of internal rate of return but do not understand adequately. Simple preferred returns challenge most draftsmen. Complex economic terms often require more than the standard form partnership agreement. Even an experienced draftsman may make economic drafting mistakes. Complicated economic schemes require thorough modeling and testing.

The state of the partnership tax law challenges partnership agreement draftsmen, no matter how able or how knowledgeable. Few draftsmen understand the alternate test for economic effect. This test in some respects is uncertain. Few practitioners fully understand the qualified income offset. Few draftsmen are comfortable with exculpatory deductions.

Target allocation provisions are common. No consensus exists on how to draft target allocation provisions. Practically no one has an adequate understanding of the tax law related to target allocation provisions. Treasury Regulations on-

\[ \text{Treas. Reg. § 1.704-1(b)(2)(ii)(d).} \]
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ly partially reveal the mysteries of partners’ interests in the partnership. The draftsman often drafts partnership allocations in an environment of uncertainty concerning the tax law.

The draftsman often is a law firm associate – or perhaps even a secretary or a paralegal. His supervisor directs him to use a form partnership agreement. The associate only partially understands the form partnership agreement. The law firm associate typically has an imperfect knowledge of both the tax law and the substantive law. The supervising partner typically gives the draft partnership agreement only a cursory examination.

The draftsman is challenged to accommodate all of these considerations. The draftsman is challenged to draft partnership agreements on a cost-effective basis. The partnership agreement draftsman should be able to defend the compromises that he makes in order to control costs. Errors and omissions in a partnership agreement may be difficult to defend when the errors and omissions result from failures of review, proofing and testing.

This is the backdrop against which most draftsmen draft partnership agreements. The draftsman has to undertake a difficult, tedious, demanding job. Potential draftsman liability is substantial. His client may not appreciate the draftsman’s work. His client may be reluctant to pay for his work. The draftsman may please his client by compromising his work and working more “efficiently.” The draftsman then may increase his personal liability and that of his firm for errors and omissions. Even a junior associate, a secretary or a paralegal may help to draft a partnership agreement that may result in law firm liability that could put his law firm out of business.

4. Ignore the Ethical and Other Legal Issues.

Simplicio is not attentive to ethical issues and other legal issues that may arise in the drafting process or later in the life of the partnership. Making ethical mistakes in the formation or operation of the partnership is an easy path to future litigation and future liability. Simplicio makes himself well liked by plaintiff’s counsel, who will entertain him in long deposition sessions. Fiduciary problems provide counsel with practically boundless opportunities to compromise a partnership agreement and the partnership relationship. Simplicio may upset clients.

7 See, e.g., Revised Uniform Limited Liability Company Act § 110(c)(4), (5) (“(c) An operating agreement may not: . . . (4) subject to subsections (d) through (g), eliminate the duty of loyalty, the duty of care, or any other fiduciary duty; (5) subject to subsections (d) through (g), eliminate the contractual obligation of good (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

faith and fair dealing under Section 409(d) . . .

(d) If not manifestly unreasonable, the operating agreement may: (1) restrict or eliminate the duty: (A) as required in Section 409(b)(1) and (g), to account to the limited liability company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business, from a use by the member of the company’s property, or from the appropriation of a limited liability company opportunity; (B) as required in Section 409(b)(2) and (g), to refrain from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and (C) as required by Section 409(b)(3) and (g), to refrain from competing with the company in the conduct of the company’s business before the dissolution of the company; (2) identify specific types or categories of activities that do not violate the duty of loyalty; (3) alter the duty of care, except to authorize intentional misconduct or knowing violation of law; (4) alter any other fiduciary duty, including eliminating particular aspects of that duty; and (5) prescribe the standards by which to measure the performance of the contractual obligation of good faith and fair dealing under Section 409(d). (e) The operating agreement may specify the method by which a specific act or transaction that would otherwise violate the duty of loyalty may be authorized or ratified by one or more disinterested and independent persons after full disclosure of all material facts. (f) To the extent the operating agreement of a member-managed limited liability company expressly relieves a member of a responsibility that the member would otherwise have under this [act] and imposes the responsibility on one or more other members, the operating agreement may, to the benefit of the member that the operating agreement relieves of the responsibility, also eliminate or limit any fiduciary duty that would have pertained to the responsibility. (g) The operating agreement may alter or eliminate the indemnification for a member or manager provided by Section 408(a) and may eliminate or limit a member or manager’s liability to the limited liability company and members for money damages, except for: (1) breach of the duty of loyalty; (2) a financial benefit received by the member or manager to which the member or manager is not entitled; (3) a breach of a duty under Section 406; (4) intentional infliction of harm on the company or a member; or (5) an intentional violation of criminal law.”); Del. Corp Code, title 6, ch. 18, § 18-1101(c), (d), (e) (“(c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant

(footnote continued on the next page)
Simplicio can face embarrassment, bar discipline, disgorge ment of his fees, and suit for errors and omissions. Simplicio does not care. Simplicio has insurance. The angels have been good to Simplicio. Simplicio believes that he has an angel on his shoulder. His angel, named Clarence, will protect him from the consequences of his carelessness.

This section mentions only a sprinkling of the many fiduciary issues surrounding partnerships. Many fiduciary issues exist for the draftsman to consider.

Simplicio habitually ignores these issues:

- What fiduciary duties does a manager or partner owe his partnership? These generally include the duty of loyalty\(^8\) and the duty of care.\(^9\)

\(\text{(footnote continued on the next page)}\)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Business decision. This may require a partner to act in a manner that is equitable and does not oppress or is unfairly prejudicial to the other partners. The partner must exercise disinterested independence in making partnership business decisions. The partner should not receive a financial benefit from the decision disproportionate from the other partners. The partnership should not receive an improper personal benefit from the decision. This may include a transaction from which the partner will receive a personal benefit in money, property, or services to which the partner is not legally entitled. The partner should act fairly in matters in which the partner has a conflict of interest. The partner should not preempt business opportunities that properly should belong to the partnership. Precisely what can constitute a partnership business opportunity can be flexible and can depend on line of business, relationship to partnership’s current activities, partnership’s financial ability to pursue the opportunity, experience, facilities, personnel, etc. The partner should not self-deal. Breaches of the duty of loyalty can include acts contrary to the best interests of the partnership, reckless disregard for the partner’s duties to the partnership, an unexcused pattern of inattention to the partner’s duties. The duty of loyalty also can be violated by intentional misconduct, knowing violation of the law, conscious disregard of the interests of the partnership, acting with malice and bad purpose, wanton willful disregard of safety, transactions from which the partner derives an improper benefit, willful misconduct and recklessness. Misusing or failing to protect partnership confidential information can breach the duty of loyalty. Cf. 6 Delaware Corporations Code § 15-103(f) (“A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”); 6 Delaware Corporations Code § 15-103(e) (“A partner or other person shall not be liable to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner’s or other person’s good faith reliance on the provisions of the partnership agreement.”). See, e.g., Pepper v. Litton, 308 US 295, 311 (1939) (“Though disallowance of such claims will be ordered where they are fictitious or a sham, [citation omitted] these cases do not turn on the existence or non-existence of the debt. Rather they involve simply the question of order of payment. [Citation omitted] At times equity has ordered disallowance or subordination by disregarding the corporate entity. [Citation omitted] That is to say, it has treated the debtor-corporation simply as a part of the stockholder’s own enterprise, consistently with the course of conduct of the stockholder. But in that (footnote continued on the next page)
situation as well as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his cestuis second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. [Citation omitted.] He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandisement, preference, or advantage of the fiduciary to the exclusion or detriment of the cestuis. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

9 The duty of care can be somewhat flexible under different acts. Some authorities debate whether the duty of care is a fiduciary duty. The duty of care is a duty to pay attention to the business of the partnership, to act without neglect, and to exercise informed business judgment. The duty of care requires a partner to exercise the same care that an ordinarily prudent person would exercise under similar circumstances. The duty of care generally involves these elements. The partner must have an opportunity to make a business decision. The duty also can be violated by a conscious failure of the partner to act when circumstances reasonably require the partner to act. The duty of care may require a partner, in making a decision, to make necessary inquiries so that the partner can inform himself of critical facts to consider in making the decision. The duty of care also may require a partner to consult with financial, accounting, legal or other appropriate professionals in making a business decision. The partner must exercise due care and good faith. The partner should exercise the due care that an ordinarily prudent person would exercise in similar circumstances. The partner should act with good faith, honesty, and integrity. The partner should make decisions in a manner to benefit the partnership rather than for his own personal gain. The partner must avoid abusing discretion. The partner’s decisions should have a reasonable business purpose. The decision should be within the permissible bounds of sound discretion. The decision should not waste the assets of the partnership for a nonbusiness purpose. Among other things, the duty of care requires that the partner be

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does the state statute exonerate partners from fiduciary duties or otherwise modify those fiduciary duties?
- Can the partnership agreement exonerate partners from fiduciary duties or otherwise modify those fiduciary duties?
- Should the partnership indemnify partners from breaches of fiduciary duties or insure partners against claims of breach of fiduciary duties?

faithful to the business. The partner is obligated to avoid self-dealing. The partner is required to use ordinary care in pursuing the business of the partnership. The duty of care generally is interpreted as a standard higher than merely exercising good faith. The duty of care, for example, can include the business judgment rule – to act to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the partner reasonably believes to be in the best interests of the partnership. In discharging this duty, a partner may rely in good faith upon opinions, reports, statements, or other information provided by another person that the partner reasonably believes is a competent and reliable source for the information. This duty of care also can be limited to a duty to refrain from conduct that is grossly negligent or reckless, intentional conduct injurious to the partnership or a knowingly violation of law. The duty of care also can be a duty to act in good faith and in a manner that the partner or manager believes to be in, or nor opposed to the interests of the partnership and with the care that an ordinarily prudent person in a similar position would use under similar circumstances. This duty also may be a duty to refrain from acting with deliberate intent to cause injury to the partnership or from acting with reckless disregard for the best interests of the partnership. Acting with gross negligence should clearly breach the duty of care. The duty of good faith and fair dealing is sometimes considered a fiduciary duty and sometimes is limited to a contractual duty – an implied contractual covenant. This duty can differ from state to state. This duty may be a general contractual duty that would exist under any contracts entered into in the state – or perhaps contracts where a special relationship exists, such as the relationship between an agent and principal or other situations in which a relationship implies trust and reliance. The duty of good faith and fair dealing perhaps a partner to act in the partner’s self-interest. The duty of good faith and fair dealing is a limited duty that courts generally are reluctant to expand. The duty of good faith and fair dealing clearly is a lower standard than the fiduciary standard to which a trustee is held. The duty of good faith and fair dealing can limit a partner and require that the partner not act oppressively and in bad faith. One of the possible aspects of the covenant of good faith and fair dealing is reasonably to share or to disclose information when needed by the other partners.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- How much do fiduciary duties bear on selection of a state for the formation of the partnership?
- What is the standard of care for duties under the partnership agreement?
- What are the fiduciary duties of a managing partner?
- What are the fiduciary duties of a nonmanaging partner? Does a nonmanaging partner own a duty of care to the partnership?
- Should a nonmanaging partner be concerned with self-dealing with the partnership?
- Should the partnership agreement reduce or modify the normal fiduciary duties of the managers?
- Does Simplicio want to limit fiduciary duties? How? Should this limitation or waiver of fiduciary duties be symmetrical and apply equally to all partners?¹⁰
- What is the standard for waiving fiduciary duties under the statute under which the partnership is organized?
- What disclosure is necessary to waive or modify fiduciary duties?
- Does Simplicio have to worry about whether a court will enforce these waiver of fiduciary duties and modifications of fiduciary duties?
- Will a court adopt a precise, limited interpretation of waiver of fiduciary duties and modifications of fiduciary duties? How precise and limited will these interpretations be?
- How should the partnership address issues such as cancellation of indebtedness income where there are intrinsic conflicts among partners?
- Should Simplicio form the partnership in Delaware, Maryland, Nevada, or some other state in order to limit fiduciary duties?

¹⁰ Counsel should be careful when the draftsman begins to limit fiduciary duties. Fiduciary duties are a primary protection of the partners. When fiduciary duties are eliminated, partners lose an important line of defense against misconduct and oppression by their fellow partners.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does Simplicio want to choose a forum to resolve disputes if Simplicio provides for limited fiduciary duties – or Simplicio anticipate other partnership disputes?
- What confidentiality requirements do fiduciary duties imply?
- What fiduciary considerations apply where the partnership leases real estate from a partner?
- What fiduciary and disclosure considerations apply when a partner options or contracts to purchase property from the partnership?
- What fiduciary considerations apply where the partnership does business with a partner or an entity controlled by or related to a partner? Should Simplicio worry about the terms being “fair”? What does “fair” mean?
- Does an unadmitted transferee of a partnership have fiduciary duties to the partnership?
- Does the partnership agreement permit the managers to weigh their own self-interest against the interests of the partnership?
- Does the partnership have an advisory committee that will approve manager conflicts?
- Does the partnership agreement have a clear procedure for the managers to present conflict issues to the partnership?
- Does the partnership agreement contain provisions under which passive investors waive categories of conflicts of interest?
- Can managers coinvest with the partnership through other partnerships in which the managers are involved?
- Is the partnership agreement fair to all of the partners or is it oppressive to some?
- Does the partnership agreement encourage conflicts between managing members and passive members?
- Are some of the terms of the partnership agreement oppressive or potentially oppressive to some partners?
- What other confidentiality provisions should the partnership agreement contain?
- Whom does Simplicio represent as counsel?
- Do the other parties understand whom Simplicio represents as counsel?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Is there any ambiguity concerning whom Simplicio represents as counsel?
- Do the other parties have counsel?
- Can Simplicio represent a partner and the partnership?
- Can Simplicio represent, as counsel, multiple partners investing in the partnership?
- Can Simplicio represent, as counsel, represent a husband and wife in forming a family entity – or investing in a third party partnership?
- Can Simplicio later represent, as counsel, the partnership if Simplicio represented a partner during the partnership organization period? What issues does this create?
- Simplicio represented husband and wife in the formation and through the operations of the partnership. Can Simplicio represent husband in a divorce from wife?
- Can Simplicio represent a partnership between father and son without a waiver of conflicts of interest if Simplicio in the past has represented father?
- Can Simplicio later represent, as counsel, other partners of the venture if Simplicio represented a different party in the formation of the venture?
- Does Simplicio have conflicts of interest as counsel?
- Are Simplicio’s conflicts of interest as counsel waivable? What is necessary for an informed waiver of conflicts of interest?
- Will Simplicio’s waiver of conflicts of interest work only for current conflicts of interest as counsel?
- Can Simplicio draft the waiver of conflicts of interest so that the waiver of conflicts of interest waives all future conflicts? Is the waiver of conflicts of interest effective?
- Does a waiver made when the partnership was formed of Simplicio’s conflict as counsel representing a promoting partner and the partnership still apply if Simplicio continues to represent the partnership and the partner during partnership operations?
- Does a formal waiver of conflicts of interest as counsel merely make the situation worse by emphasizing the conflicts to the partners?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Does it make sense for Simplicio to have the partners and the partnership waive the conflicts of interest as counsel?
- Does Simplicio’s client have the business sophistication to understand the waiver of conflicts of interest?
- Is Simplicio’s client giving informed and voluntary consent in waiving the conflict? How much information is necessary for the consent to be informed? Can client intelligently waive the conflict if client is not represented by counsel in assessing the waiver of conflicts of interest?
- Is a waiver of conflicts of interest letter without a clear description of the nature of the conflict and the potential effects of the conflict, effective?
- Does Simplicio’s client objectively have to understand the waiver of conflicts of interest?
- What information is privileged from the other partners when Simplicio represents the partnership and a partner?
- To what extent do the managing partner’s communications with Simplicio, as counsel, have privilege vis-à-vis the other partners?
- When does the law apply privilege to a nonmanaging member’s conversations with Simplicio as counsel and prevent disclosure to the other members?

[11] American Bar Association Model Rule 1.0(e) (“‘Informed consent’ denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct.”). Does the conflicts letter all pertinent conflicts issues. Does the letter provide an overview of the facts relevant to the conflict? Does the conflicts letter review benefits and disadvantages of the waiver. Two important reasons not to waive are that conflicting representations can compromise the attorney’s zeal in the representation. He serves conflicting masters. The waiver also can lead to compromise of confidential communications or information. There also may be further future divergence of interest of the parties and even possible litigation between the parties. Counsel may be forced to withdraw and to represent neither party in the case of future disagreements between the conflicting parties.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Does Simplicio, as counsel, have an affirmative obligation to report on problems with the manager or managing partner to the partnership as a whole?
- Can Simplicio as counsel, without special disclosure to the partnership, prepare provisions that indemnify that Simplicio?
- Simplicio prepares a partnership agreement as counsel to the partnership and is paid by the partnership. When must Simplicio resist the instructions of the general partner in drafting the partnership agreement?
- When should Simplicio, as counsel, question whether instructions from the managing member conflict with the interests of the partnership? What obligations does Simplicio have?
- Simplicio, as counsel, discovers a scrivener’s error in the partnership agreement. Is Simplicio obligated to point this out to the partnership? When?
- What does Simplicio, as counsel, ethically need to do if he enters into a partnership with his client?
- Can Simplicio drafting a partnership agreement send intermediate drafts directly to other potential partners if another law firm represents those partners? Must Simplicio have permission from the other counsel? Must that permission be written or confirmed in writing?
- Simplicio, who drafted a partnership agreement for his client, a managing partner, discovers that his client is trying to defraud the other partners. May Simplicio communicate that information to the other partners or to criminal authorities?
- Can Simplicio reveal to another partner Simplicio’s client’s criminal convictions of his client if that other partner asks Simplicio whether his client can be trusted?
- Does Simplicio, as counsel, commit an ethics violation of failing to act competently if, acting with inadequate knowledge of the tax law, he drafts partnership allocations that Simplicio is unaware are unlikely to work?
- What conflicts of interests may the various investors have?
- Can the entity do business with a managing or nonmanaging partner? What waiver of conflicts of interest or disclosure is required for the entity to do business with a managing or nonmanaging
partner? What business terms are required for the entity to do business with a managing or nonmanaging partner?

- When do business opportunities belong to the venture?
- What are managers’ and members’ obligations to safeguard trade secrets and other confidential or proprietary information?
- What are the rights of partners to trade secrets and other confidential or proprietary information after the termination of the partnership?
- What are the rights of partners to files and customer lists after the termination of the partnership?
- What are the rights of partners to partnership clients after the termination of the partnership?
- What obligations do partners have with respect to partnership account receivables after termination of the partnership?
- When is special disclosure of information or business opportunities of the partnership to other partners required?
- What partnership information can the partnership withhold from partners?
- When does a managing partner have an affirmative obligation to disclose bad news to the partnership?
- When can a managing partner withhold information from partners and nonadmitted assignees of partnership interests?
- When can a partner withhold from disclosure to the partnership outside business information of which the partner has special knowledge?
- Can a partner purchase a partnership obligation if the partnership is in financial straits? Under what conditions and with what disclosures can the partner undertake this transaction?
- What special considerations apply under labor law when the partnership admits as a partner a former employee of a partner transferring his business to the partnership?
- What special considerations apply under labor law when the partnership admits an employee of the partnership as a partner?
- What the special considerations apply under labor law when a partner works as an employee of the partnership?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does the partnership have to worry about discrimination in employment against a partner?
- What considerations apply when a partner lends money to the partnership?
- What considerations apply when a managing partner wants the partnership to employ his children?
- What ethical considerations apply when a managing partner causes his partnership to employ his high school age son as temporary help during the summer?
- What considerations apply when a managing partner uses partnership employees to improve his personal residence or to work on his car?
- When must a managing partner resign as managing partner? Can a managing partner have a fiduciary duty to resign as managing partner under certain circumstances?
- How does the partnership deal with neglect by a managing partner? How does the partnership establish this neglect? Who is in charge of establishing this neglect? Does a nonmanaging partner have an obligation to report or to take action with respect to this neglect?
- What should concern a managing partner who is personally involved in a number of related businesses (outside of the partnership) in the same geographical area?
- Can a managing partner pay personal expenses through the partnership? If not, what are “personal expenses” that he cannot pay through the partnership?
- What information must the partnership give to an unadmitted transferee of a partnership interest?
- Can an unadmitted transferee of a partnership interest compete with the partnership?
- What information rights does a partner have?
- What information rights does an unadmitted transferee of a partnership interest have?
- How much time does a partner have to spend on the business of the partnership?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Can a partner compete with the partnership? Does it matter whether the partner is in a managing role? What constitutes competition with the partnership?
- Can a former partner compete with the partnership? Under what conditions will a court enforce a covenant not to compete?
- What information disclosures must the partnership make to new partners?
- Will partnership agreement provisions be subject to state law concerning liquidated damages?
- Will state or federal labor law test the admission or buyout of the partnership interest of a partner/employee?
- What can a partnership do/not do in order to encourage a partner to sell his partnership interest to the partnership or the other partners?
- When can a partnership reasonably deny consents to transfer of a partnership interest if the other partners want to harass a partner?
- When is business information the property of the partnership?
- How does the partnership deal with the disability of a partner? What is the “disability” of a partner? How does the partnership establish disability? Who establishes this disability? Does the partnership have a right to order a partner to undergo a medical examination in order to establish disability? Will the results of the examination be privileged?
- How does the partnership deal with the possible senility of a partner? How does the partnership establish senility or other lack of capacity? Does the partnership have the right to subject the partner to a psychiatric examination? Will the results of the examination be privileged?
- How does the partnership deal with the incompetent, misfeasant, or malfeasant partner? How does the partnership establish incompetence, misfeasance, or malfeasance?
- To what extent should the partnership agreement provide for indemnification of agents, employees and independent contractors of the partnership?
- When does a money partner with participation or consent rights over management have to be concerned that these rights may create liability exposure?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- What is the standard of consent when a partner has the power to consent to an action?

5. Do It Yourself By Yourself.

Simplicio drafts partnership agreements entirely on his own.

Independence has merits.

Independence can create problems.

Simplicio knows how to work by himself. He believes in “do it yourself.” He does not associate in his work other professionals with specialized expertise that may pertain to partnership issues. Simplicio avoids working with the accountants and other professionals who may have information relevant to the partnership. Simplicio does not prepare numerical models of economic provisions – or cause these models to be prepared. Simplicio does not bother to attach examples to the partnership agreement. Simplicio does not involve secretaries and paralegals in review and proofing.

Preparing the partnership agreement by himself makes Simplicio’s drafting process less expensive and more efficient. Preparing the partnership agreement by himself avoids the nuisance of others finding defects in Simplicio’s partnership agreement during the drafting process. The partnership may not discover defects in drafting the partnership agreement until situations arise that test these provisions. Then, litigators invigorate the process. By then, Simplicio can be ready to take an extended vacation in a far-away country that does not speak English.

Simplicio prefers to isolate accountants from the drafting process. The accountants can review the partnership agreement when the time comes to prepare the partnership’s tax returns.

Isolating accountants from the planning and drafting process usually is false economy for Salviati. Isolating accountants from the drafting process is a good way to compromise the partnership agreement. Secretaries, paralegals, and other attorneys usefully can review the draft partnership agreement. Simplicio may be surprised at what problems reviewers would discover.

Accountants can provide a number of benefits to the planning and drafting process. Accountants –

- Can bring understanding about the client and his business.
- Can bring understanding of the current project.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Can bring understanding of foreign, federal, state, and local income tax effects that the draftsman otherwise may not have.
- Can bring financial sophistication to the business deal.
- Can bring understanding of assets to be transferred to the partnership agreement.
- Can prepare economic projections and models.
- Can undertake basis projections.
- Can model effects of Section 704(c).
- Can undertake disguised sale computations.
- Can model economic provisions of the partnership agreement.
- Can model tax allocations in the partnership agreement.
- Can review the partnership agreement and determine whether they understand it.
- Can determine effects of the formation of the partnership under generally accepted tax principles.
- Can identify and can help to resolve tax, accounting, or business issues that the draftsman may have missed.


One of the greatest indictments of a partnership agreement is when clients, accountants, and others cannot understand it. The draftsman is responsible for his audience understanding the partnership agreement. “My partnership agreement is clear, and they should have understood it” usually is not an adequate excuse. Small, seemingly innocent mistakes can prove a problem in a partnership agreement. Salviati ensures that his partnership agreement is readable.

Simplicio’s form partnership agreements are larded with unreadable legalese. The language is dense and impenetrable. Paragraphs are long and forbidding. Sentences can be interminable. Clients often feel that it takes an attorney to understand the partnership agreement.

Simplicio drafts in a stilted contractual language that only lawyers can understand. Simplicio’s agreements may be difficult to enforce if disputes reach arbitration or court trial. Simplicio is content if lawyers can understand his partnership agreements. He does not write partnership agreements for the common man.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

A jury will have difficulty interpreting language that ordinary people do not understand. Trial by jury is the decisive test of drafting partnership agreements. The partnership agreement perhaps is not quite as good as Simplicio may imagine if the partnership agreement does not stand up at trial or in arbitration.

Accountants often have difficulty following tax allocation provisions when they are preparing partnership tax returns. Many accountants routinely ignore partnership agreements, particularly their tax allocation provisions. They then prepare tax returns based on what they think is right.

These are common drafting style and drafting language flaws in partnership agreements that Salviati seeks to avoid. For Simplicio, this is a checklist of how to prepare his partnership agreements. Simplicio considers pompous legalese a symbol of his prestigious status as a member of the bar.

- Unreadable English.
- English that might easily have come out of the 1600’s.
- Confusing short names for the parties.
- Terms in Latin or other foreign languages.
- “Said” this and “said” that as adjectives.
- “Such” this and “such” that as adjectives.
- Parties of the first, second, third, fourth, and fifth part.
- Using long or complex words where simple words are clearer.
- Excessive “notwithstanding” clauses.
- Poorly chosen “notwithstanding anything herein to the contrary” introductions.
- Excessive “provided, however” clauses.
- Sequences of “provided, however” clauses.
- Confusing “provided however” clauses.
- Nonparallel use of words of phrases – using them to mean different things in different parts of the document.
- Long chain cross-references.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Inaccurate cross-references.\(^{12}\)
- Cross-references to provisions that do not exist.
- Inverted sentences that do not begin with the subject of the sentence.\(^{13}\)
- Compound sentences.
- Complex sentences.
- Long, seemingly interminable sentences.
- Long, seemingly interminable paragraphs.
- Long verb sequences – particularly redundant verb sequences.
- Other redundancies, such as redundant word pairs.
- Unnecessary multiple adjectives – particularly redundant adjectives.
- Wordiness.
- Groupings composed of a series of nouns.
- Avoidable passive voice.
- Failure to use active verbs.
- Split infinitives.
- Misplaced modifiers.
- Unclear antecedents.
- Writing in the negative where writing in the positive is clearer.
- Plural forms where singular forms are clearer.
- Exceptions where more direct statements are clearer.
- Future tense where writing in the present tense is clearer.
- Strings of synonyms or near synonyms.

\(^{12}\) It is good practice to verify all cross-references in the partnership agreement.

\(^{13}\) A simple form of drafting a sentence that starts with the subject, follows with the verb, and ends with the object can produce understandable partnership agreements.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Incomprehensible and obtuse language that nonspecialized readers cannot understand.
- Ambiguous and imprecise language (particularly, ambiguous pronoun antecedents).
- Double negatives.
- Wordy expressions.
- Lack of conceptual precision – confused drafting.
- Lack of white space on the page.
- Percentage interests that do not sum to 100%.
- Incomprehensible letter abbreviations.\(^\text{14}\)
- Other abbreviations that are difficult to understand.
- Abbreviations with definitions spread through the text of the agreement rather than isolated in one place.\(^\text{15}\)
- Overlap of provisions where two separate provisions appear to apply, but say different things.
- Partnership agreements that discuss the same issue in two different provisions.
- Long agreements with few titles or subtitles.
- Long agreements without tables of contents.
- Poorly organized partnership agreements.
- Omitted or incomplete exhibits.
- Failure to define defined terms.
- Two different defined terms for the same concept.
- Failure to use defined terms where defined terms are appropriate.
- Improper use of defined terms.

\(^\text{14}\) Consider using understandable short names rather than letters as abbreviations. Letter abbreviations, however, are appropriate for entitles that have commonly-used letter abbreviations, such as “NFL” for the National Football League.

\(^\text{15}\) Consider concentrating all abbreviations in a section of the partnership agreement.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure adequately to anticipate, to think through, and to address problems that the partnership will encounter during its life.
- Unsigned signature blocks.
- Undated agreements.
- Ambiguity.
- Obscurity.
- Vagueness.
- Complexity.

Salviati seeks to follow the Federal Plain Language Guidelines\(^\text{16}\) for ideas on drafting language. Understandable writing is commendable, whether one adheres to the concept of “plain English” or not. Some of the recommendations in these federal guidelines include these guidelines:

- Write for the audience.
- Organize to meet readers’ needs.
- Use useful, informative headings.
- Write short sections.
- Write shorter paragraphs that are easier to follow.
- Avoid long, dense paragraphs.
- Choose words carefully – be precise and concise.
- Use active voice.
- Use the simplest form of a verb (which usually is the present tense).
- Use the strongest, most direct form of the verb.
- Use “must” for an obligation.
- Use “must not” for a prohibition.

---

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Use “may” for a discretionary action.
- Use “should” for a recommendation.
- Do not use words that readers will not understand.
- Do not use abbreviations that confuse readers.
- Avoid or minimize noun strings.
- Put information in a logical order.
- Use pronouns that clearly refer to a specific noun. A pronoun could refer to more than one person or object in a sentence. Then, repeat the name of the person or object or rewrite the sentence.
- Minimize abbreviations.
- Instead of abbreviations, use “nicknames” – a simplified name for the entity you want to abbreviate. Using meaningful names aids readers to understand the names.
- Always define an abbreviation the first time you use it.
- Do not use jargon or technical terms when everyday words have the same meaning.
- Avoid jargon and legalese.
- Use words and terms consistently throughout your documents.
- Use short, simple words.
- Avoid stodgy, long, dry legalisms and other jargon.
- Use the familiar or frequently used word over the unusual or obscure.
- Omit unnecessary words.
- Avoid wordy, dense construction.
- Put the definitions section at the beginning or end of your document.
- Limit definitions to defining terms.
- Avoid substantive provisions in definitions.
- Do not define words or phrases that you do not use.
- Use the same term consistently for a specific thought or object.
- Avoid legal, foreign, and technical jargon.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Do not leave out necessary technical terms, but ensure your other language is as clear as possible.
- Substitute everyday language for jargon as often as possible.
- Ensure you define your terms when you have no way to express an idea except to use technical language.
- Avoid archaic jargon such as “above-mentioned,” “aforementioned,” “foregoing,” “henceforth,” “hereafter,” “hereby,” “herewith,” “thereafter,” “thereof,” “therewith,” “whatsoever,” “whereat,” “wherein,” and “whereof.”
- Avoid “and/or.”
- Write short sentences.
- Express only one idea in each sentence. “Sentences loaded with dependent clauses and exceptions confuse the audience by losing the main point in a forest of words. Resist the temptation to put everything in one sentence; break up your idea into its parts and make each one the subject of its own sentence.”
- Keep subject, verb, and object close together. “The natural word order of an English sentence is subject-verb-object. This is how you first learned to write sentences, and it’s still the best. When you put modifiers, phrases, or clauses between two or all three of these essential parts, you make it harder for the user to understand you.”
- Avoid double negatives.
- Avoid exceptions to exceptions.
- Place the main idea before exceptions and conditions.
- Use numbers or letters to designate items in a list if future reference or sequence is important.
- Keep subjects and objects close to their verbs.
- Put conditionals such as “only” or “always” and other modifiers next to the words that they modify.
- Put long conditions after the main clause.
- Write short paragraphs.
- Include only one topic in each paragraph.
- Use examples to clarify complex subjects.
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements** and  
**Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

- Use vertical lists to present items, conditions, and exceptions.
- Minimize cross-references.
- Organize material to minimize the need for cross-references.
- If a cross-reference refers to brief material, repeat that material and eliminate the cross-reference.
- A cross-reference to long and complicated material will avoid repeating that long and complex material.
- The reference should clearly describe the referenced material.
- Consider putting cross-references at the end of the text, like a reference, rather than in the middle.
- Design your document for easy reading.
- Avoid cluttered and dense documents.

Salviati uses examples to illustrate numbers oriented provisions.

Salviati considers these principles from the Federal Register’s rules for Drafting Legal Documents:

- Prepare an outline.
- Establish a single principle of division and use that principle to divide the subject matter into major topics.
- Arrange the items within a topic in a logical sequence.
- Place general provisions before specific provisions.
- Place more important provisions before less important provisions.
- Place more frequently used provisions before less frequently used provisions.
- Place permanent provisions before temporary provisions.
- Place administrative provisions (such as effective date provisions) and penalty provisions at the end.
- Use headings for each designated component.
- Descriptive headings should illustrate the logic and arrangement.
- Write in the active voice.
- Use action verbs.
- Use “must” instead of “shall”.

---

48
Be direct. Talk directly to your readers. Use the imperative mood.

Use the present tense.

Write positively where possible.

Avoid use of exceptions where possible.

When you use an exception, state the rule or category first then state its exception.

Avoid split infinitives.

Use the singular noun rather than the plural noun to the extent possible.

Do not use different words to denote the same things.

Use parallel structure.

Prefer simple words.

Do not use compound prepositions and other wordy expressions when the same meaning can be conveyed with one or two words.

Put instructions in simple, concrete words.

Choose language that will not antagonize readers.

Avoid clustered groups of nouns.

Write short sentences.

Make lists clear and logical.

Use parallel structure for lists.

List each item so that it makes a complete thought when read with the introductory text.

If the introductory language for the list is a complete sentence–

End the introduction with a colon; and

Make each item in the list a separate sentence.

If the introductory language for the list is an incomplete sentence –

End the introduction with a dash;

End each item in the list except the last item with a semicolon;

After the semicolon in the next-to-last item in the list, write “and” or “or” as appropriate; and
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- End the last item in the list with a period.
- Use short paragraphs.
- Use cross references sparingly and carefully.
- Avoid these words: abeyance; above [as an adjective]; above-mentioned; afore-granted; afore-mentioned; aforesaid; before-mentioned; henceforward; hereby; herein; hereinafter; hereinbefore; hereunto; pursuant; said [as a substitute for “the”, “that”, or “those”]; same [as a substitute for “it”, “he”, “him”, “she”, or “her”]; thenceforth; thereunto; therewith; to wit; under-mentioned; unto; whatsoever; whenssoever; wheresoever; whereas; whereof; whosoever; within-named; witnesseseth.

7. **Just Start Drafting.**

Simplicio starts the drafting process by talking to his client, taking notes on the deal, marking up an old form partnership agreement, preparing a draft, and sending the product to his client for review. Negotiations begin with the draft partnership agreement. This model provides the illusion of drafting efficiency. This model provides the illusion of being inexpensive.

This model may not produce the best-finished product. Simply starting the drafting process marking up a draft can lead to inconvenience and inefficiency. The partnership agreement based on simply marking up an old draft of a partnership agreement from a different deal is a promising route to a compromised partnership agreement.

Salviati follows this procedure:

- Salviati moves from his initial deal notes to a written deal outline. The deal outline discusses and summarizes the basic provisions of the partnership agreement. The deal outline serves to highlight basic deal points.
- Salviati circulates the deal outline to his client.
- Salviati refines the deal outline to ensure that the deal outline represents Salviati’s client’s view of the transaction.
- Salviati circulates the deal outline to the other parties to the partnership agreement.
- Salviati negotiates the deal outline until the parties reach agreement.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Salviati revises the deal outline.
- Salviati starts drafting the partnership agreement only after Salviati finalizes the deal outline.

8. Rely on the Form Agreement.

A partnership agreement draftsman may start the partnership agreement drafting process by marking up a form from a prior deal or a generalized partnership agreement form. The use of forms in modern legal practice is inevitable. Forms are important and reasonable accommodations to the economic reality of legal practice. A good all-purpose form can serve as an excellent outline of points that a draftsman should consider in the partnership agreement. Forms provide useful language for the new partnership agreement. Good forms make drafting more economical. Few draftsmen draft partnership agreements from scratch. Practically every draftsman uses forms. Reliance on form agreements from prior transactions or reliance on general forms is practically inevitable.17

Religious, unquestioning adherence to forms frequently results in compromised partnership agreements. Simplicio believes that his heavy-duty forms are appropriate for every situation. Simplicio believes that his heavy duty forms deal with every contingency. Circumstances rarely confirm the truth of these beliefs.

Relying innocently and unquestioningly on a partnership agreement from a prior deal, a form book, or a firm form library can create problems. Forms do not substitute for thought and judgment about the current deal. Overreliance on forms can be a good way to compromise a partnership agreement.

Blind reliance on form agreements is particularly a problem when the draftsman is an inexperienced associate. He may not easily detect subtle problems in a partnership agreement form. Partners who make themselves unavailable to junior associates drafting the partnership agreement are an effective route to a compromised partnership agreement.

Using a form agreement is inevitable. Salviati, however, should take the time necessary fully to review and to understand the form.

The prior partnership agreement typically had its own nuances. The prior partnership agreement often has negotiated language. Many decisions went into

17 For most draftsmen, the form agreement is considerably less dangerous than simply starting to type a partnership agreement from scratch, without any guide at all. It is doubtful that many draftsman have tried this approach.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

drafting the partnership agreement for the prior deal. The parties made many decisions in drafting the form agreement.

Simply copying an old form without thought can result in provisions or language inappropriate for the current partnership agreement. Simply copying an old form can result in incorporating decisions – often closely negotiated decisions – that may not be the best decisions for the current deal. Simply copying an old form sometimes can result in carrying over party names and economic provisions from the prior deal. Even generalized forms from law firm form libraries or from formbooks can have provisions that are not fully appropriate to the current partnership agreement.

Using a form, particularly a familiar form, is a good starting point. While form agreements are a good starting point, religious devotion to general forms can be problematic.

Many attorneys belong to a forms cult. They try to practice by making minimal revisions to established forms. They try to make each new partnership conform to the established form.

General forms often contain errors and value judgments. General forms fail to take into account the special concerns of the individual deal. Each form makes compromises. The compromises that may be acceptable in one transaction may not be acceptable for another. What is appropriate for one deal often is inappropriate for another. No single, homogeneous all-purpose form partnership agreement is fine for all purposes.

Salviati rereads the form beginning to end, provision by provision, with each new transaction in order to determine what language is valuable for Salviati’s current deal and what language may not be appropriate for the current partnership agreement. Salviati reviews the prior form as an outline of decisions. Salviati ensures that the decisions incorporated in the prior form are appropriate for his current partnership agreement. Salviati ensures that he have thoroughly read and examined the prior form before he uses the form as a basis for his current drafting project.

Salviati is careful when his clients instruct him to use the client’s own form as a starting point in drafting a partnership agreement. The client often is infatuated with inferior work incorporated in that prior partnership agreement – or with judgment calls that may have been appropriate for a prior deal, but may not be appropriate for the current deal. Salviati may find his client fighting any drafting improvements that Salviati will want to make. Salviati may find important errors in the form. Salviati will seek fully to understand his client’s form.

Using the client’s form partnership agreement can result in the perpetuation of errors or ambiguities across a number of partnership transactions. Using a
client’s form typically increases the cost of drafting a partnership agreement if Salviati does a diligent job – which he does.

Salviati follows these steps:

- Review the form with particular care if Salviati has not previously worked with the form.
- Ensure that the form is appropriate for the state in which the partnership is to be formed. A Michigan state form may not work well for a Delaware partnership.
- Verify whether the form has been updated for changes in the law.
- Ensure that the form is designed for the type of business for which Salviati is currently drafting. A form designed for one business may not work well for a partnership conducting a different business. Provisions may be industry specific.
- Ensure that the “weight” of the form (short form, medium form, long-form) is appropriate for the current purpose.
- Ensure that Salviati’s new partnership agreement does not carry forward names, addresses, economics, and other information from a prior deal.


A partnership agreement for a real estate partnership or an up-REIT partnership often will contain restrictions on the ability of the partnership to sell contributed property in a taxable transaction. The partnership agreement then typically will contain a tax protection agreement. The lock-in agreement and tax protection agreement offer practically boundless ways in which Simplicio can compromise the partnership agreement. Most partnership agreements that cover contributions, lock-ins, and tax protection are defective to a greater or lesser extent. Salviati works carefully with partnership accountants to ensure that his tax protection agreements provide a reasonable estimate of potential tax.

Tax protection provisions are easily compromised. These provisions always are a challenge to draft. Major law firms have made major mistakes in drafting tax protection provisions. Simplicio drafts these provisions without the cooperation of accountants. Simplicio prefers to live dangerously. Simplicio prefers to draft inexpensively.

The accountants usually better understand the nuances of computing tax liability than the attorneys do. Working with accountants who regularly prepare tax returns might have helped the drafting process. It is much quicker to avoid the
accountants and merely to disregard special tax considerations. Simplicio can ignore tax considerations completely and can leave the tax considerations to the accountants when these considerations arise.

Salviati considers:

- What is a reasonable lock-in period?
- Under what circumstances can the up-REIT sell contributed property?
- How long a lock-in period does the partnership agreement provide for?
- Does the lock-in provision interfere with the possibility that the up-REIT will receive a favorable one-time offer for the property during the lock-in period?
- How should a like-kind exchange exception to the lock-in be drafted?
- How does the partnership agreement deal with the possibility of boot?
- How does the partnership agreement deal with the possibility of an attempted but failed exchange?
- What is an appropriate lock-in period?
- How does a partner enforce the lock-in?
- Should the lock-in sale prohibition during the lock-in period be absolute?
- Can the up-REIT contribute contributed property to a subsidiary partnership?
- Do limitations that applied to the up-REIT partnership apply to the subsidiary partnership after the contribution?
- Is there an agreement on Section 704(c) method?
- Does the Section 704(c) method agreement apply if there is a contribution to a subsidiary partnership?
- Is that subsidiary bound by the agreement on Section 704(c) method?
- Is a transferee partnership bound by a lock-in agreement?
- Under what circumstances can the up-REIT transfer the contributed property during the lock-in period?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- What are tax protected events during the lock-in period?
- What income or gain is subject to tax protection during the lock-in period?
- Does the tax protection agreement apply to a partnership merger used to freeze out the partnership interests of the up-REIT units?
- Is there tax protection if a sale by the up-REIT interferes with the qualification of a Section 1031 exchange by the contributing partner?¹⁸
- How do revaluations of assets and redeterminations of capital accounts affect the computation of tax indemnification payments?
- What formula is used for the tax protection payments?
- How does the tax protection agreement deal with state taxes?
- Does the tax protection indemnification formula consider FICA, Section 1411, Medicare/Medicaid, tax surcharges, cutbacks of deductions, etc.?
- Does the tax protection indemnification formula consider the possibility of changes in the law related to service partnership interests?
- Does the tax protection indemnification formula consider different rates for different character of income?
- Does the tax protection indemnification formula consider state of residence or other states in which the indemnified person may be taxable?
- Does the tax protection indemnification formula consider local taxes?
- Does the tax protection indemnification formula consider the possibility of changes of residence of the indemnified person?
- Does the tax protection indemnification formula consider possible changes in the tax law?
- What is the procedure for initiating the tax protection mechanism?

¹⁸ Note that the recognized gain normally will not be Section 704(c) gain if the prior exchange is disqualified. Tax protection agreements typically are limited to gain allocated to the contributing partner under Section 704(c).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Who calculates the tax protection payment?
- How does the partnership agreement handle disputes with respect to calculation of the tax protection payment handled?
- How does the partnership agreement handle disputes with respect to indemnified events?
- What persons receive the benefit of the tax protection agreement?
- Will the tax indemnification payment be taxable to the indemnified party? If so, is there a gross-up formula for tax on tax?
- Is there a clawback of tax indemnification payments when a partner who has received tax indemnification payments when he sells his partnership interest?
- Does the tax protection agreement provide contributing limited partners with minimum amounts of partnership debt?
- Is there an opportunity to guarantee partnership debt?
- How do the documents handle the transition and what steps does the partnership agreement require if the partnership wishes to repay existing partnership debt?
- How does the partnership handle the situation if the partnership requires the partnership to provide an opportunity to guarantee minimum amounts of partnership debt and lenders are unwilling to lend as much on a refinancing of partnership debt?
- How does the partnership handle guarantees of pools of partnership debt under the tax protection agreement?
- How does the partnership handle subsequent guarantees of portions of the pool of debt by other partners under other tax protection agreements?
- How does the partnership handle refinancings?

10. Tax Issues With Which Simplicio Can Compromise the Partnership On Formation.

The formation of each new partnership gives Simplicio abundant opportunity for tax problems. Simplicio ignores these issues. Salviati will consider these issues. This is a partial list of common formation issues:

- Sales tax.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Property tax.
- Documentary transfer tax.
- Disguised sale rules.
- Section 704(c). The partnership agreement should set forth asset valuation on an asset-by-asset basis.
- Gain from relief of liabilities.
- Potentially invalidating an exchange under Section 1031(a).
- Potentially invalidating a nontaxable involuntary conversion under Section 1033.
- At risk and at risk recapture.
- Effects of passive loss rules in the new partnership.
- Effects of lock-in agreements and holes in lock-in agreements.
- Withholding related to foreign tax provisions (e.g., FIRPTA).

Salviati’s partnership agreement clarifies who will bear transaction taxes and expenses associated with the formation of the partnership. Simplicio will shorten his partnership agreement by ignoring these issues.

A wide variety of considerations, nontax approvals and regulatory issues might be associated with the formation of a partnership. Salviati considers these issues. Simplicio will shorten his partnership agreement by ignoring these issues. These issues can include:

- Insurance.
- Labor Laws.
- Indemnifications.
- Warranties.
- Licenses and permits.
- Contracts and agreements.
- Service agreements.
- Real estate development rights.
- Employee agreements.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Collective bargaining agreements and guild agreements.

11. Get the Economics Wrong.

Simplicio may seriously compromise a partnership agreement by getting the partnership economics wrong. One of Salviati’s objectives is to get the economic deal right. Salviati works closely with the partnership accountants in order to ensure that the partnership agreement economics confirm with Salviati’s clients plan for the deal. Salviati is anxious to have the accountants model all of the economic provisions and the economic adjustment provisions in his partnership agreements in order to ensure that everyone will understand them.

Getting the economics wrong easily can subject Simplicio to suit for errors and omissions. Other drafting mistakes can cause Simplicio embarrassment.

An errors and omissions lawsuit for getting partnership economics wrong can be a high point in Simplicio’s career. Simplicio suddenly becomes the focus of attention in discovery, in deposition, and at trial. Plaintiff’s counsel entertains Simplicio in long depositions. He can fill his days responding to discovery. Simplicio no longer has to be a quiet wallflower. He is the life of the party.

A plaintiff in an errors and omissions lawsuit might use any errors in the partnership agreement, even seemingly immaterial errors, against Simplicio. The partnership’s malpractice attorney might use any errors in the partnership agreement to suggest that the drafter’s work was below the accepted standard of care. These errors might cast a shadow on other work in the partnership agreement. These errors might suggest that Simplicio’s care in drafting the partnership agreement was below the accepted standard of care.

Any errors in a partnership agreement could embarrass Salviati. These errors do not trouble Simplicio. He emphasizes drafting efficiency and low cost. Simplicio can tolerate a reasonable rate of errors.

19 Many partnership agreements have errors like these: spelling errors, grammar errors, cross-reference errors, incorrect numbering of provisions, inconsistent format style, incorrect description of property, redundant provisions, contradictory provisions, incorrect party names, omitted exhibits, missing signatures, missing dates or other blanks, incorrect addresses or telephone numbers, columns of numbers that do not add properly, and percentage interests that do not sum to 100%. These errors may seem immaterial. These errors may create an impression that the draftsman is careless or incompetent.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Simplicio protects against premature discovery of these problems. Simplicio ensures that accountants or analysts do not model partnership economics. Simplicio ensures that paralegals and secretaries do not proof the partnership agreement. Simplicio scrupulously avoids putting pen to paper (or fingers to keyboard) and running numbers-based examples of his economic provisions.

Simplicio may wonder how he can get the partnership economics wrong. It often is easy to get the partnership economics wrong. The task of getting the basic distribution economics right can be easy in a simple 50:50 deal.\textsuperscript{20} The task of getting the basic distribution economics right can become vastly more complicated as the partnership agreement introduces tiered returns, preferred returns, returns based on internal rates of return, different deals with respect to different categories of events (e.g., normal operations, refinancing, sale), and different deals with respect to different pools of assets.\textsuperscript{21}

Preferred returns and returns based on internal rates of return are difficult to draft. Many draftsmen are not adequately trained in mathematics. Many partnership agreements with preferred returns and returns based on internal rates of return are deficient. The draftsman may only have a vague understanding of his internal-rate-of-return-based provisions.

Tax distribution provisions and other special distribution provisions complicate partnership economics. Some tax distribution provisions in large partnership transactions are dramatically wrong. Draftsmen often do not adequately understand the mechanics of their tax distribution provisions.

The drafting task is complicated when events (such as forfeiture or squeeze-down provisions) adjust capital accounts. Asset revaluations and capital account redeterminations complicate the drafting task. Economic adjustment provisions initiated by defaults on capital contributions can increase the difficulty of getting the economic deal right. This increases the importance of \textit{pro forma} modeling of the partnership agreement during the drafting period.

\begin{itemize}
  \item \textsuperscript{20} Even a simple percentage based partnership agreement can become much more complicated when new partners are admitted midway in the history of the partnership.
  \item \textsuperscript{21} These more complicated economic deals suggest even greater importance in the draftsman cooperating with the accountants, who should model the economic provisions of the partnership agreement.
\end{itemize}
Admitting new partners (particularly service partners) midway through the deal can complicate partnership economics. Salviati knows to treat the tax distribution as a recoupable draw that may be subject to clawback at liquidation if not fully earned. Simplicio does not trouble himself with this.

Implementing squeeze-down provisions can create economic issues, particularly when some of the partners have service partnership interests. The enforceability of punitive squeeze-down provisions becomes uncertain when they operate as penalty provisions or as disguised liquidated damages provisions. Squeeze-down provisions should be modeled with pro forma numbers during the drafting period.

Providing for buy-out rights, put rights, drag-along rights, tax-along rights, conversion rights, liquidation rights, or expulsion rights can further complicate partnership economics and can raise enforcement concerns.

The drafting task can be particularly challenging when the partnership includes partners who received partnership interests as consideration for the performance of services (“carried interests”). Capital contributions may not fully reflect partnership economics. These provisions typically break down when partners receive service partnership interests. Admitting service partners who receive profits interests can complicate the economics.

Hurdle provisions in distribution provisions are some of the most difficult economic provisions to draft. The drafting difficulty can result from Simplicio’s failure to understand the precise nuances of computing interest or his failure to

---

22 Among other things, the admission of a partner will cause the varying interests rule to apply for allocations. This admission may make it sensible to revalue assets and to redetermine capital accounts.

23 The draftsman should consider the possibility of state law labor issues with service partners.

24 Provisions often adjust percentage interests based on the ratio of capital contributions. Such a formula may fail to give proper weight to the service contributions of service partners. Service partnership interests may be wiped out by these adjustments. On service partners generally, see REG-105346-03 (May 24, 2005) (proposed regulations relating to receipt and grant of a partnership interest in consideration of the performance of services).

25 A particular concern is where provisions provide for readjustment of partnership economics based on unrecovered capital contributions. The service partner often is disfavored by these provisions unless these provisions are drafted with care.
understand how tiered distribution arrangements work. This makes modeling these provisions particularly important.

Simplicio disregards computational nuance.

Simplicio often does not quite get the economic deal right – for any of a number of reasons.

Simplicio routinely gets the economic deal wrong.

Simplicio manages sometimes to get the economic deal dramatically wrong.

This makes recycled forms particularly dangerous. Recycled forms often contain major errors.

Simplicio keeps accountants, financial analysts, and others outside of the drafting process. Simplicio avoids financial modeling of partnership economic provisions (distributions, liquidations, squeeze-downs, etc.). These steps aid Simplicio’s efforts to get the deal wrong and to conceal these mistakes until a time when the damage is difficult to repair.

Disputes among partners concerning partnership economics are common. These disputes may be virulent. These disputes may be expensive. Disputes disrupt the health and good order of the partnership. These disputes provide work for litigators. Simplicio creates abundant work for his litigation colleagues. The litigators are appreciative. Simplicio might have avoided or at least mitigated the disputes through more careful modeling of partnership economic provisions and attaching examples to the partnership agreement.

Salviati clarifies whether the return base bears the preferred return on the date of contribution and on the date of distribution. Salviati clarifies how the preferred return works for partial periods of less than one year. Salviati clarifies the computational period and the computational year. Salviati considers the computational effects of irregular accrual periods. Salviati considers whether lower-tier distributions help to satisfy upper-tier hurdles. Salviati considers compounding conventions and compounding frequency. Salviati is clear on whether the annually stated preferred return rate is equal to an annual effective date that should be converted to a per period compounded rate that equals the stated annual effective rate. Salviati is careful about whether his clients want to use a set rate, compounded at stated periods, or an effective rate, compounded at stated periods, that is economically equivalent to a stated annual rate. Salviati is familiar with the pre-

---

26 One useful technique is to state a daily accrual rate for the preferred return.  
27 An annual rate compounded monthly generally involves dividing the annual rate by 12 and using that rate as the monthly rate. A monthly compounded rate can be calculated using the formula: $\text{Compounded Rate} = (1 + \text{Monthly Rate})^{12} - 1$. This formula represents the annual effective rate equivalent to a stated monthly rate. It is crucial to understand the difference between stated and effective rates and to ensure that the correct compounding frequency is used in the agreement to avoid disputes.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

cise computational nuances of discounting future cash flows and discount computations involving irregular computational periods. Salviati is careful to have the accountants model the preferred return.

Simplicio does not have to worry about any of this nonsense. Simplicio relies on his errors and omissions insurance – and his protective angel – when matters go wrong. Simplicio puts his faith in his insurance company – and in the angels who protect him.

Simplicio is indifferent to how much is at stake in the partnership and how complicated the economic deal is.\(^{28}\) Simplicio’s care and review of the partnership agreement is indifferent to the dollar size and complexity of the transaction. Simplicio’s standard partnership agreement is good enough for a large deal if the partnership agreement is good enough for a small deal. Simplicio saves time by reusing his old partnership agreement form with minimal changes for each new deal. He needs only to proof the new provisions. The old provisions worked well enough for the old deal. Simplicio does not need to review the entire agreement. Simplicio uses this approach to save his client money in drafting and review time. Simplicio works quickly, efficiently, and economically. Simplicio can repair any problems that develop when they develop.

Budget considerations constrain review of a partnership agreement for a small-dollar-size deal. Clients typically do not want to spend much for a partnership agreement for a small dollar deal. This suggests making the partnership agreement shorter and simpler so that the draftsman can review the partnership agreement economically. The shorter agreement for the smaller deal can rely more on basic principles of state law to fill in the blanks in the agreement.

Simplicio may use a long-form partnership agreement for the simple deal. Simplicio may merely mark up the provisions most affected by the current deal. Simplicio simply trusts the other provisions without review. This practice can reduce drafting cost efficiencies. This practice can produce interesting dialogues when someone reads the partnership agreement.

Simplicio ensures that his partnership agreement has not been independently reviewed, proofed, and verified. All of this extra work is expensive. This is needless expense to Simplicio. Besides this, review of the partnership

economically equivalent to an X% annually compounded rate is determined by the formula \(x = X^{1/12} - 1\). The conversion formula for daily compounding depends on the day count convention. It might be \(x = X^{1/365} - 1\) or \(x = X^{1/366} - 1\) depending whether the year is a leap year. The conversion formula might be \(x = X^{1/360} - 1\) for a 360-day year.

\(^{28}\) Making small economic deals economically complex is not recommended.
agreement can discover problems with the agreement. These problems then may prove expensive to correct. What difference will misspellings, grammatical errors, incorrect cross references, nonsense provisions from the prior deal, incorrect definitions, incorrect parties, etc., make? Simplicio can explain these faults as scriveners’ errors. Drafting should be inexpensive in order to meet client mandates for a cost-efficient product. The draftsman must draft economically in order to compete for legal business.

Modeling the economics of the partnership agreement with spreadsheets and bombarding the computer model with examples –

- Is routine for Salviati.
- Is unnecessary, wasted expense to Simplicio.
- Is expensive.
- Permits the modeler to bombard the model with scenarios. These scenarios can include both results expected in normal operations and extreme results of unusual events.
- Permits stress testing the partnership agreement.
- Permits Salviati to avoid many economic mistakes and ambiguities.
- Is particularly important in clarifying the economics of promotional partnership interests.
- Can reveal drafting mistakes or ambiguities that then must be corrected at additional expense.
- Can permit investors to understand how the partnership agreement will work in realistic and extreme scenarios.
- Can detect differences between the partnership agreement and what the parties believe the economic deal to be.
- Can detect ambiguities in the economic provisions of the partnership agreement.
- Can identify at the drafting stage that the parties disagree on what the economic deal is.
- Makes it more difficult for Salviati to prepare a partnership agreement at odds with the partners’ concept of the deal.
- Can force Salviati to correct the partnership agreement for less likely or unanticipated events.
Simplicio avoids cooperation with the partnership accountants and other financial analysts in preparing a computer model that adequately models the economics of the partnership agreement.

The draftsman has the task of correctly describing the economic deal in the partnership agreement. He may have to prove in court that he has gotten the economics right. Salviati anticipates that his client’s recollection of instructions and discussions may differ from his own. Salviati can prove that his client has approved the economic nuances of the partnership agreement. Salviati can prove that he has properly carried out his client’s instructions. The draftsman should consider the contents of, and preserving, notes, memoranda, letters, drafts, spreadsheets, schedules, electronic mail, time sheet entries, and other evidence of the drafting process. In this regard, the draftsman should consider discussing the appropriateness of preserving raw notes, circulation drafts, intermediate unaddressed drafts, and annotated drafts with his litigation colleagues. These colleagues may be able to provide useful insights. The draftsman should consider preparing summary memoranda after meetings and telephone calls. The draftsman should consider preparing a lay term sheet that will help better to communicate with his client the contents of a complex partnership agreement. Circulating numerical models of economic provisions and securing written confirmation that they accurately reflect the economic deal can be useful.

Simplicio –

- Assumes that his client’s recollection of the client’s instructions later will be consistent with Simplicio’s recollection of these instructions.
- Is not be concerned about having later to demonstrate that he has followed his client’s concept of deal economics.
- Is indifferent to proving that he has properly explained the economics of the partnership agreement to his client, that his client has understood the economics, and that his client has approved the economic scheme reflected in the partnership agreement. In this regard, the draftsman should consider preserving proof that will convince a jury in an errors and omissions action.
- Relies on his errors and omissions insurance – and on his protective angel. That is why insurance companies offer errors and omissions insurance.
a. **Numerical Examples.**

Opportunities for getting the economics wrong are practically unlimited. Salviati carefully works through all of the economic provisions of his partnership agreement. Simplicio will not worry about numerical examples. Salviati will test each of the economic provisions (distributions, tax distributions, liquidation, buy-out, and squeeze-down) with numerical examples. These examples can include normal examples of scenarios consistent with economic expectations and extreme examples of scenarios that stress the provisions of the partnership agreement. Some of the provisions Salviati may test include:

- **Tax distribution provisions.** Concerns can include the federal and state tax rates, surcharges, self-employment taxes, Medicare taxes, changes in the tax law, phaseouts of deductions, and precisely what income is subject to tax distributions. The draftsman should consider the effects of net loss allocations, offset against other distribution provisions, and clawback provisions. The draftsman should consider whether tax distributions should be made after the liquidation of the partnership commences. The draftsman should consider whether the same tax distribution provision should be used for all partners, or whether a different formula should be used, for example, for corporations and individuals. The draftsman should consider how to compute tax distribution payments to pass-through entities and to real estate investment trusts. The draftsman of a partnership agreement that includes a tax distribution provision should work with the partnership accountants in drafting the tax distribution provision; the accountants can use their experience in preparing tax returns in designing the tax distribution.

- **Normal distribution provisions for cash from operations.** We can raise many possible concerns with normal distribution provisions. These concerns can include defining cash from normal operations, cash from refinancings, and cash from capital events. These concerns can include division of distributions within a distribution tier, distribution tier hurdles, and whether lower-tier distributions are counted against upper tier distribution hurdles.

- **Preferred return hurdles.** Preferred returns often have errors and generally have drafting ambiguities. One of the most common errors is lack of clarity about whether a lower-tier distribution is counted against satisfying an upper tier preferred return hurdle. For example, if the partnership agreement contains a tier 1 preferred return to partner A and a percentage split between partner A and partner B in tier 2, assume that the partnership distributes in year 1 $80,000 to partner A under tier 1 and $100,000 each to partner A
and partner B under tier 2. Does the $100,000 tier 2 distribution to partner A count against satisfaction or the tier 1 hurdle when that hurdle is applied in year 2? The preferred return requires precise identification of when contributions are deemed made and when distributions are deemed made. The preferred return requires precise definition of whether the computational year begins on the date of contribution or the calendar year. The preferred return requires definition of whether it is based on a 365/366-day year, a 360-day year and actual days elapsed, or any of a number of conventions for computational years of 360 days and 30-day months. The preferred return requires a definition of whether the computational year is concurrent with the calendar year or whether it begins on the date of contribution and runs to the anniversary of the date of contribution. The preferred return requires whether the return is paid for day of contribution and day of distribution. The preferred return required precise definition of computational periods, compounding frequency, and compounding date. A preferred return provision should avoid terminology like “first, distributable cash will be distributed to partner A until partner A has received a preferred return equal to 8%.” Partner A typically will never receive precisely an 8% preferred return. Partner A will go from a preferred return slightly less than 8% to a preferred return slightly greater than 8%. The condition of distributions equal to an 8% preferred return never will be satisfied. This problem is epidemic in poorly drafted partnership agreements. The preferred return requires a precise definition of the base used in computing the preferred return. Further, it is important precisely to clarify when the preferred return begins and ends.

• **Clawback provisions.** Clawback provisions are common in many partnerships, particularly securities partnerships and real estate investment funds, especially where there are service partnership interests. These clawback provisions require clawbacks of distributions from promoter partners if the partnership fails to meet performance benchmarks. These clawbacks for the service partnership interest often reflect situations in which the partnership has multiple economic units, such as investments in different pools of assets or businesses. Drafting the economics of these clawback provisions is particularly difficult and often is done badly. Clawbacks for the service partnership interest often do not work properly even for large funds. Modeling partnership clawback provisions is particularly important. Clawbacks for the service partnership interest often are not adequately drafted. Partnership agreement also may
have clawback provisions when service partners have returns that cross a variety of partnership projects. The service partner may receive a preferred return based on the economic performance of a particular project, with an clawback or adjustment provision when the performance of other projects is determined.

- **Goal seek.** Accountants often will use the goal seek function in Excel in order to determine when distributions have satisfied a preferred return hurdle. Depending on the size of numbers involved, it may be important to change the iteration increment parameters.

- **Return hurdles based on internal rate of return.** Few attorneys drafting distribution hurdles based on internal rates of return adequately understand internal rates of return. Many financial analysts have no more than a general understanding of internal rates of return. Internal rates of return are intrinsically difficult to compute. Computing internal rate of return includes all of the concerns for preferred returns. A carefully drafted provision for internal rate of return should consider possible multiple solutions for internal rate of return. The partnership agreement should identify which solutions should be accepted or rejected. The internal rate of return provision should exclude nonreal complex number solutions. Otherwise, the partnership may be put to the test of whether an internal rate of return condition might be satisfied by a complex number internal rate of return. The internal rate of return computation is sensitive to the computational formula. This formula should be stated explicitly. The draftsman should consider what computational periods are appropriate. The draftsman should consider whether grouping of cash flows is appropriate. The draftsman should consider whether grouping of cash flows can distort computations if the formula involves periodic grouping of cash flows. Grouping of cash can distort the internal rate of return computations. Grouping of cash flows can encourage manipulative behavior in distributing cash. Some partnership agreements define internal rate of return in terms of the Excel IRR function or the Excel XIRR function. These functions may produce different results in different versions of Excel. The Excel IRR function produces different results than the Excel IRR function. Some partnership agreement require that Excel be used to compute internal rate of return but fail to identify which Excel function should be used to compute internal rate of return. Some partnership agreements used the Excel IRR function for irregular compounding periods. Some partnership agreements fail adequately to convert from an annually compounded return rate to a proper periodic return rate. Excel may fail to find a solution. Ex-
cel occasionally may find a completely erroneous solution on account of an unusual pattern of cash flows. The Excel XIRR function assigns cash flows to particular days. XIRR uses a spreading convention to deal with a year of 366 days. The Excel IRR function groups cash flows into periodic cash flows. The use of the Excel IRR function can produce economic distortions. Neither the IRR nor the XIRR function in Excel clearly identify when there are multiple real number solutions to internal rate of return. (Other solutions can be found by using guesses in the IRR or XIRR function.) Multiple solutions can be identified by graphing net present values against discount rates. Multiple solutions can be identified using Sturm’s Theorem; however, applying Sturm’s Theorem and expanding Sturm functions involves more computational work than most partnership agreement draftsmen will wish to undertake. Draftsmen who use internal rate of return hurdles are particularly encouraged to have the accountants model the economic provisions in order to ensure that the parties understand how the provisions will work. Defining internal rate of return by reference to Excel’s XIRR or IRR function is intrinsically dangerous. Defining internal rate of return by reference to Excel’s XIRR or IRR function can lead to misadventure. The equation for internal rate of return should be expressed as a formula in the partnership agreement. Internal rate of return provisions may be accompanied by minimum dollar returns to ensure that the financial partner’s financial expectations are not thwarted by premature distributions than can distort the internal rate of return computations. Another possibility is to require that the partnership property be held for a minimum period before sale or distribution of refinancing proceeds.

- **Distribution provisions for cash from capital events.** This provision should carefully define “cash from capital events” and expenses that are charged against this pool. The partnership should clearly indicate the order of application of the various distribution provisions.

- **Distribution provisions for cash from financings and refinancings.** Cash from financings and refinancings often, but not necessarily, is distributed under the provision for distributing cash from capital events. The partnership agreement should carefully define “cash from financings and refinancings.” The partnership agreement should carefully define the order of distributions and what expenses are charged to the pool of cash from financings and refinancings.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- **Special distribution provisions for isolated pools of assets.** The partnership agreement should define carefully the order of distribution provisions, increases and decreases to the pool, and what expenses are charged to the pool.

- **Distribution provisions for liquidation of the partnership.** The partnership agreement should clearly indicate when the liquidation period begins and whether returns continue during the period of liquidation. The partnership agreement should clarify whether tax distributions are made during the period of liquidation.

- **Provisions that adjust capital accounts and partnership economics on defaults on capital contributions.** Squeeze down and similar provisions that adjust capital and percentage interests can have a wide variety of effects. The draftsman should consider how these provisions operate for service partners. Service partners often are disadvantaged by poorly drafted squeeze down provisions that base adjustments purely on contributed capital. The draftsman should consider whether adjustments should consider the time at which capital was contributed. The draftsman should trace effects through all economic provisions to see how adjustments under the squeeze down provision affect all of the economic provisions of the partnership agreement. The draftsman should consider the enforceability of punitive squeeze down provisions.

- Puts, calls, and similar arrangements.

- Economic provisions regarding the redemption or retirement of a partner.

- Definitions of economic terms.

- **Cross-references in provisions that affect partnership economics.** Incorrect cross-references to economic provisions in a partnership agreement plague many partnership agreements. It never is clear when these mistakes are innocent and when a court will enforce them.

Salviati is particularly concerned about testing and providing clear examples when the partnership agreement provides for a deal-by-deal waterfall rather than a waterfall that crosses all transactions that the partnership undertakes. Salviati is careful to model the economic provisions of any clawbacks of distributions to the managers for service partnership interests. Salviati provides clear examples of the operation of clawback provisions.

The partnership accountants may undertake similar tests of these provisions. Salviati will circulate spreadsheets with numerical results. Salviati then can
seek confirmation from clients and other parties to the deal that the examples correctly reflect how the partnership agreement works. Salviati will preserve these spreadsheets in the permanent records of the partnership or of a partner. Salviati will secure confirmation from other parties that the examples in spreadsheets are consistent with the manner in which the partnership agreement is supposed to work.

Salviati attaches numerical examples as exhibits to the partnership agreement. This is an effective technique to preserve the examples. This technique also is effective to show agreement that the examples correctly show the parties agreement of how the partnership agreement should work. These numerical examples can provide guidance to accountants and others in interpreting the partnership agreement in the future. These numerical examples can be useful if the partners dispute the economics of the partnership agreement.

All of this work is expensive and burdensome. Simplicio avoids this work. Simplicio imagines that the partners will accept whatever economic results pop up in the partnership agreement that they sign.

Partners can significantly reduce the cost and frustration of preparing a partnership agreement by innocently accepting whatever distribution provisions the partnership agreement contains. Simplicio will be ensconced on the beach on some Caribbean island sipping piña coladas by the time the parties discover the economic problems. Besides, the United States will not extradite partnership agreement draftsmen for errors and omissions in drafting partnership agreements.

This is a typical example of Simplicio’s work where he managed to get the economics wrong. In his economic provisions, Simplicio defined “Unreturned Contributions” in this manner:

“Unreturned Contributions” of a Member at any time means the excess, if any, of (a) the aggregate amount of Contributions in money or property by such Member through such time, over (b) the aggregate amount distributed to such Member pursuant to Section 8.6(b)(i) through such time.”

Simplicio’s partnership agreement contained this distribution provision:

(b) The Company will make additional Distributions in cash to the extent there is Distributable Cash. Any amount that is distributed under this Section 9.6(b) will be distributed to the Members in the following order of priority:

(i) Distributions to the Members will be made under this Section 9.6(b)(i) until the Members will have received distributions under this Section 9.6(b)(i) equal to their total Unreturned Contributions. These distributions will be distributed to the Members in proportion to their respective Unreturned Contributions.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(ii) Any remaining Distributions will be distributed 65% to von Rundstedt Advisors and 35% to Damascus Holdings.

This provision looks fine. It appears that the distribution provision first returns invested capital and then splits further distributions 65/35. That is not exactly the way in which it works.

This shows a series of distributions and their effects on Unreturned Contributions:

<table>
<thead>
<tr>
<th>Contribution</th>
<th>von Rundstedt Advisors</th>
<th>Damascus Holdings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Starting Unreturned Contribution</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Year 1 Distribution</td>
<td>($150,000)</td>
<td>($150,000)</td>
</tr>
<tr>
<td>Unreturned Contribution After Year 1</td>
<td>$350,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>Year 2 Distribution</td>
<td>($150,000)</td>
<td>($150,000)</td>
</tr>
<tr>
<td>Unreturned Contribution After Year 2</td>
<td>$250,000</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

The distribution in year 1 reduces each member’s Unreturned Contribution to $350,000. That much seems to make sense.

The distribution in year 2 is anomalous. Distributions in year 2 are made under Section 9.6(b) equal to the Members’ total Unreturned Contributions. At the beginning of year 2, each member’s Unrecovered Contribution has been reduced to $350,000. At this point, each member has received a distribution equal to $150,000. Each distribution of $1 under Section 9.6(b) reduces Unreturned Contributions by $1.

The distribution of an additional $100,000 in year 2 to each of von Rundstedt Advisors and Damascus Holdings reduces each member’s Unreturned Contribution to $250,000. At that point, each member has received a distribution under Section 9.6(b) equal to the member’s Unrecovered Contribution.

Further distributions are made under Section 9.6(b)(ii).

The problem is that each member will have recovered only one-half of its contributed capital under Section 9.6(b)(i). This is a common drafting fault. The problem is that Section 9.6(b)(i) should have been drafted to provide as a hurdle the point at which the members had received distributions equal their contributions rather than their Unrecovered Contributions.


Simplicio can make a series of common mistakes when drafting distribution provisions.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure to provide clear hurdles for moving from one tier to another.
- Failure clearly to allocate among partners in a tier.
- Careless use of “until.”
- Careless use of “equal to.”
- Failure to clarify whether tiers are reapplied each year.

One of Simplicio’s typical provisions reads like this:

Clause 1. Distributions of Distributable Cash from Operations. Subject to applicable law, the Manager will cause the Company to distribute Distributable Cash from Operations to the Members. The Company will make these Distributions in the following order of priority:

(a) first, one hundred percent (100%) to the Members until each Member’s has received distributions equal to a 6% preferred return on its Invested Capital; and then

(b) second, to the Members until each Member’s Adjusted Capital Contribution has been reduced to zero (0); and then

(c) finally, to the Members in proportion to their Percentage Interests.

This distribution provision is littered with flaws. Some flaws are easily recognizable. Some flaws are more subtle.

It is axiomatic that each tier of Clause 1 should address both how much cash is distributed under the tier, but also how that distribution is divided among the various partners. Clause 1 fails clearly to state how distributions under Clause 1 are divided among partners. This could create unnecessary confusion.

Clause 1 is ambiguous concerning what a “6% preferred return on its Invested Capital” means? Is this return compounded? If this return is compounded, when does it compound and how often? Is the return prorated and applied on a daily basis, weekly basis, monthly basis, quarterly basis, semiannual basis, or annual basis? If the return is prorated, then how is it prorated? Does 6% return to an actual return rate or an economic equivalent return rate? Is the return computed for the date of contribution and date of distribution? Are only distributions under this first tear counted?

Also, it is very possible that the return will go from very slightly under a 6% return rate to slightly over a 6% return rate. The return may never be precisely equal to a 6% return. Should the clause be interpreted, contrary to its language, to mean a 6% or greater return?
The distribution provisions may be applied several times each year and in each subsequent year. Assume that the 6% hurdle is met in year 1. One could argue that the 6% hurdle should not be reapplied in year 2 because the hurdle condition already was satisfied in year 1. This approach would be nonsense. The language of Clause 1 at least admits this misguided possibility.

As discussed above, there may have been distributions in year 1 under the first and second tiers. One might argue that prior distributions under the second tier made in year 1 also should be counted in applying the 6% return tier in year 2. This ambiguity could have been corrected through more careful drafting. The distribution could have clarified that, whenever a distribution is made, each distribution tier and each test in each distribution tier is reapplied without reference to whether the test was satisfied when applied previously. Alternatively, the test could be drafted something like this: “First, one hundred percent (100%) to the Members while the distributions received by each Member under this Section have not been sufficient to give the Member a 6% or greater preferred return on its Invested Capital, with the preferred return measured from the formation of the Company. Distributions are distributed under this Section among the Members in accordance with the ratio of the minimum current distribution, computed for each Member, necessary to give the Member a 6% or greater preferred return on its Invested Capital, with the preferred return measured from the formation of the Company.”


Simplicio confuses distributions of cash and allocations of income. A single provision can work for both distributions of cash and allocations of income. The partnership agreement can just say that distributions of cash will follow allocations of income – or allocations of income will follow distributions of cash. This design of partnership distributions often assures Simplicio of preparing a compromised partnership agreement. Provisions of this type are particularly vulnerable when the partnership distributes first available cash to return capital investments.29

29 In one limited partnership, the limited partners contributed $6 million of capital. The general partners made no capital contributions. The partnership agreement distributed first cash flow to the limited partners until they recovered their $6 million capital contribution. The partnership agreement afterwards distributed cash flow 40% to the general partners and 60% to the limited partners. The partnership agreement allocated all taxable income to the partners in accordance with distributions of cash flow. The partnership provided for liquidating dis-
d. Liquidating Distributions In Accordance With Capital Accounts.

Tax regulations on substantial economic effect\(^{30}\) encourage partnership agreement draftsmen to design their partnership agreements to distribute the proceeds of liquidation in accordance with capital accounts.\(^{31}\) This works well if distributions in accordance with positive capital account balances. Very roughly, the partnership distributed the first $6 million of cash to the limited partners. The partnership allocated roughly $6 million in income to the limited partners. The partnership then went into liquidation. The general partners were not pleased when they discovered that their capital accounts totaled roughly zero, while the capital accounts of the limited partners totaled roughly $6 million.

\(^{30}\) Treas. Reg. § 1.704-1.

\(^{31}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d) (“(d) Alternate test for economic effect. If – (1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and (2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and (3) The partnership agreement contains a ‘qualified income offset,’ such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and (5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and (6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made ‘(other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner’s capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership (footnote continued on the next page)
partnership capital accounts have values consistent with the economic deal. Liquidation in accordance with capital accounts may not work well if capital accounts have values inconsistent with the economic deal. Simplicio may compromise partnership economics if his partnership agreement distributes the proceeds of liquidation in accordance with capital accounts. Instead, Simplicio distributes the proceeds of liquidation in accordance with tiers defined by percentages or similar indices (without reference to capital accounts).

Even Salviati may worry that capital accounts will not be consistent with the economic deal. Salviati may determine that that risking the possibility that the Internal Revenue Service will disallow partnership tax allocations is better than to risk the possibility that cash will go to the wrong partner.

When Salviati provides for liquidating distributions in accordance with positive capital account balances, Salviati ensures that the partnership accountants have modeled partnership allocations and projected capital account results.

e. Determining Operating Cash Flow and Proceeds of Capital Events.

Partnership agreements often are imprecise in establishing and segregating pools of cash for distribution. Operating cash flow and proceeds of capital events are two common pools. The partnership agreement might clarify what cash the partnership agreement credits to, and what expenses the partnership agreement charges to, each of these pools. The partnership agreement needs detailed accounting rules that clearly determine when different expenses are charged against different economic pools. The partnership agreement needs detailed accounting rules that clearly determine what cash is credited to different pools. Consider ac-

minimum gain)' under section 1.704-2 (f). For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a ‘qualified income offset’ if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners’ interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. . .”).
counting issues such as capital expenses, reserves, insurance recoveries, installment sales, deposits,


Some talented big firm lawyers have made extraordinarily large mistakes in drafting tax distribution provisions. Making mistakes in drafting tax distribution provisions is easy. Drafting tax distribution provisions is difficult. Tax distribution provisions often contain errors. Getting the tax distribution provision precisely right is enormously difficult and requires substantial drafting effort.

One question usually is how close is close enough? Another question is: to what extent does the provision be flexible to take into account future changes in the law? A further question is: to what extent should the provision address the individual tax circumstances of the partner?

The tax distribution provision merely approximates the tax liability of the partner attributable to the partnership. Even experienced tax lawyers generally do not routinely prepare individual tax returns. Experienced tax lawyers often are oblivious to issues than might affect tax distribution provisions. Simplicio is oblivious to these issues.

Tax distributions normally should be advances against a partner’s share of distributions. Simplicio fails to identify tax distributions as advances and fails to provide for recoupment of tax distributions from other distributions or clawback. Salviati’s tax distribution provision clearly charges tax distributions against the cash distributions otherwise payable to the partner, including future cash distributions. The partner otherwise may receive the tax distribution money twice. Salviati provides a clawback of excess tax distributions at the liquidation of the partnership or the liquidation of the partner’s partnership interest in case the partnership has not fully recouped tax distributions from other cash distributions to the partner.

Defining the mathematics and mechanics of tax distribution provisions challenges Salviati. Salviati works closely with partnership accountants in order to ensure that his tax distribution provisions work. Simplicio does not worry about these challenges. Salviati’s concerns include:

- Is the tax distribution provision designed so that the recipients will not make a profit on tax distribution payments?
- Should the formula be individualized to the circumstances of the partner receiving the tax distribution?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Are tax distribution payments mandatory or discretionary?\(^{32}\)
- At whose discretion does the partnership make the payments?
- What happens if the partnership does not have enough cash to make tax distribution payments currently?\(^{33}\)
- What formula does Salviati use to calculate tax distribution payments? The formula might be individualized to the type of partner and its residence. The formula also might be standardized. Some advisors believe that the same formula should be used for all partners. The formula should consider both federal and state taxes and the federal deduction for state taxes. The formula might consider character of income and the rates at which income of different characters is taxed. The formula might consider tax surcharges and other changes in the tax law. The formula might consider social security and Medicare taxes. The formula might consider the partner’s state of residence. One partner might want to formula individualized to a partner’s tax circumstances. Another partner might insist that a consistent single formula be used for all tax distribution payments to all partners. Accountants are particularly helpful in structuring and drafting the tax distribution formula.
- The tax distribution provision might provide estimated payments corresponding to estimated tax dates.
- What tax rate should the partnership agreement use for tax distribution payments, or should the partnership agreement use multiple rates in order properly to reflect character of income?
- Should the tax distribution provision be based on assuming the highest hypothetical marginal tax rate (or highest hypothetical marginal tax bracket) in a designated location, or on the actual tax situation of the recipient?
- Does the computation consider past tax benefits that the partner may have received from the partnership?\(^{34}\)

---

\(^{32}\) Some partnership agreement make tax distribution payments at the discretion of a manager or general partner. Minority partners often feel more comfortable with mandatory tax distribution payments.

\(^{33}\) The partnership may be forced to borrow or to sell assets to raise cash to make tax distribution payments if the partnership agreement does not provide relief when the partnership does not have available cash show.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does the computation consider past cash distributions to the partner?\(^{35}\)

- Should the partnership agreement consider past loss allocations and past tax credit allocations to a prior partner (but predecessor in interest) in computing tax distribution payments?

- Does the formula consider changes in tax law, FICA, Medicare/Medicaid,\(^ {36}\) tax on investment income, alternative minimum tax, and tax surcharges?

- Does the tax distribution provision consider state income tax?\(^ {37}\)

- If so, what state income tax should the tax distribution provision consider?

- Should the tax distribution provision consider the taxes of more than one state?

- Does the formula consider the distributee partner’s type of entity in computing notional taxes?

- Should the partnership agreement use the same tax rates for all partners in computing tax distribution payments?

- Does the tax rate consider the type of tax person that is the partner (individual, corporation, \textit{etc.})?

- How does the formula work for pass-through entities that are partners?\(^ {38}\)

- Does the formula work for real estate investment trusts?\(^ {39}\)

---

\(^{34}\) Some tax distribution formulas offset prior tax-effected benefits, such as tax losses, against current tax distribution payments.

\(^{35}\) A tax distribution formula might offset prior cash distributions against current tax distribution payments.

\(^{36}\) The maximum rate for Medicare taxes is increased to 3.8\% beginning in 2013 for taxpayers with high incomes. The highest rate applies to taxpayers who are married filing separately with income above $250,000. The highest rate applies to taxpayers who are single with income above $200,000.

\(^{37}\) There also can be a problem of a partner taxable on the same income in more than one state.

\(^{38}\) Pass-through entities generally do not pay tax. Nevertheless, their income passes through and is taxable to their partners.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should tax distribution payments be made to exempt partners?  
- What is the tax treatment of tax distributions to a partner?  
- Should the provision indemnify tax on tax?  
- What income is subject to tax distribution payments?  
- Does gain allocable under Section 704(c) qualify for tax distribution payments?  
- Does gain allocated as if under Section 704(c) (reverse Section 704(c)) qualify for tax distribution payments?  
- How does the partnership offset tax distribution payments against other distributions?  
- Is there a clawback provision is tax distribution payments, based on estimates, prove to be excessive?  
- What are the details of the tax distribution clawback provision?  

A real estate investment trust may be taxable as a C corporation on its income or that income may be distributed to its shareholders, so that the income would be taxable to those shareholders as ordinary or capital gains dividends.  

A taxable partner might believe that the tax-exempt entity should not receive any tax distributions at all, unless the income is unrelated business taxable income. The tax-exempt entity nevertheless could insist on tax distribution payments to it in order to maintain proper partnership economics.  

Tax distribution payments might be considered to be guaranteed payments under certain circumstances.  

The partnership might make tax distribution payments on all partnership income, or the partnership might exclude Section 704(c) gain from tax distribution payments. The partnership likely should make tax distribution payments on reverse Section 704(c) allocations.  

Partners may believe that it is inappropriate to provide tax distribution payments for Section 704(c) gain since that gain was the partner’s personal tax problem when he entered the partnership.  

Reverse Section 704(c) gain is related to a rebooking of partnership assets. This gain normally should qualify for tax distribution payments.  

The tax distribution normally is a draw against the partner’s other distributions. This requires a recoupment mechanism under which the partnership can recoup tax distribution payments against other distributions made to the partner.  

The partnership normally should be able to recover excess tax distribution payments made to the partner in excess of distributions otherwise payable to the partner.  

(footnote continued on the next page)
**SOME COMMENTS ON HOW TO COMPROMISE DRAFTING**
**PARTNERSHIP AND LLC AGREEMENTS AND**
**SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS**

- Is there a clawback provision if income and losses are revised on audit?
- Does the partnership make tax distribution payments after the buy-out of the partner’s partnership interest is initiated under a buy-sell provision?
- Does the partnership make tax distribution payments after the partnership begins liquidation? 
- When does the partnership make tax distribution payments?
- How does the partnership agreement handle disputes regarding calculation of tax liability payments?
- Is the partnership obligated to pay interest if the partnership makes a tax distribution payment late?

**g. Preferred Returns.**

Drafting the mathematics and mechanics of preferred returns can be challenging. Considerations include:

---

partner. These amounts might be clawed back on the liquidation of the partner or on the liquidation of the partnership.

47 The typical response is that tax distribution payments should terminate at the beginning of the liquidation of the partnership.

48 Tax distribution payments might be made during the first quarter of the immediately following year or might be adjusted to correspond with estimated tax payment due dates. If tax distribution payments are made to correspond with estimated tax payment due dates, there normally should be some reconciliation provision in case tax distribution payments are in excess of those that are calculated for the entire year.


(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- When does the preferred return begin?
- When does the preferred return end?
- What is the return rate?
- Does the partnership need to adjust this return rate on account of the frequency of computational periods and compounding?  

50

- How is the preferred return calculated for periods of less than one year? Is the preferred return prorated? How?
- Are returns calculated on an asset-by-asset basis or on an aggregate basis for the partnership?
- Are loans made to the partnership or to another partner included in determining the preferred return of a partner? If so, which loans are included?

An annual return rate may have to be exponentially adjusted to convert the annual rate into a periodic compounded rate for a shorter period.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Are preformation expenses included in computing the base for the preferred return?
- Are external expenses incurred by a partner included in computing the base for the preferred return?
- Does the preferred return involve day-by-day computations?
- Does the partnership agreement group cash flows in weekly, monthly, quarterly, semi-annual, or annual groupings of cash flows?
- Does the partnership compound the preferred return?
- What are the compounding frequency and the compounding dates?
- When does each compounding period commence and end?
- What is the computational year?\(^{51}\)
- When does the computational year begin and end?\(^{52}\)
- Does the preferred return run from the date on which the partner contributes capital to the partnership to the date on which the partnership returns the invested capital to the partner?
- What is the day count convention? Common conventions include “30/360 US,” “30U/360”, “30E/360”, “30E/360 ISDA,” “30E+/360,” “Actual/Actual ICMA,” “Actual/Actual ISDA,” “Actual/365 Fixed,” “Actual/360,” “Actual/365L,” and “Actual/Actual AFB.” Many of these methods have multiple names. These conventions differ by the manner in which they treat the number of days in the year and the manner in which they treat the first or last day of the interest calculation period if the first or last day of the month is the 30th or 31st day and the manner in which they treat February 28 and 29. At least three accepted actual/actual methods exist for computing bond interest accrual on a 365/366-day computational year: the International Securities Market Association (ISMA) method (“Actual/actual (bond)”), the Association Française des Banques (AFB) method (“Actual/actual (AFB)”), and the Inter-

\(^{51}\) The computational year might begin on the date of contribution and end on the anniversary of that date. The computational year might correspond with the calendar year. The significance is in determining the number of days during the computational year in order to establish the daily accrual of the preferred return.

\(^{52}\) See note 51.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

national Swaps and Derivatives Association (ISDA) method (“Actual/actual (Historical”). Each method can produce different interest or preferred return accruals.\(^53\)

- Does the partnership compute the preferred return for a contribution for the date on which a partner contributes capital?\(^54\)
- Does the partnership compute the preferred return for the date on which the partnership makes a distribution?
- What is the base of preferred capital against which the return rate is applied?\(^55\)
- Is the partnership agreement clear concerning what events adjust this base and on what date the partnership makes adjustments?
- What contributions increase the base against which the preferred return is applied?
- When does the partnership pay the preferred return?


\(^{54}\) The convention for commercial loans is for interest to be paid on the date of deposit of funds. It is not clear whether there is any established convention for partnership preferred returns.

\(^{55}\) The convention for commercial loans is for interest not to be paid for the date of payment of the loan. It is not clear whether there is any established convention for partnership preferred returns. Preferred capital normally includes traditional capital contributions, but preferred capital also may include certain pre-organizational expenses. Preferred capital also may include certain partner loans to the partnership. A partner also may be credited with preferred capital, but not with a capital contribution, for entering into guaranteed of partnership obligations or undertaking other services for the partnership. Preferred capital also may be subject to adjustment under adjustment formulas.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Does the partnership pay the preferred return after the fiscal year in which the preferred return accrues?
- Does the partnership consider distributions under distribution tiers below the preferred return tier in determining whether the partnership has met a preferred return condition?
- Does the partnership make preferred distributions of the preferred returns on liquidation?\(^{56}\)

The partnership agreement may provide for this tiering of distributions (to be applied on a cumulative basis from the formation of the partnership):

1. First, to partner A until partner A has received sufficient cumulative distributions to give partner A an 8% preferred return.
2. Second, 50% to partner A and 50% to partner B.

In year 1, the partnership makes sufficient distributions to satisfy partner A’s 8% preferred return. The partnership also distributes $100,000 to partner A and $100,000 to partner B under tier 2 in year 1.

The partnership must calculate distributions in year 2. Does the partnership count the year 1 distribution to partner A under tier 2 in applying the 8% preferred return condition in year 2?

- Does the partnership pay preferred returns to one partner economically out of the capital of another partner?\(^{57}\)
- Does the partnership pay preferred returns out of operating cash, proceeds of refinancing, or proceeds of sale?
- In what order does the partnership assign the preferred return to these three categories of cash?
- Who computes the preferred return?
- How do partners handle computational disputes?

\(^{56}\) Depending on how the preferred return operates on liquidation, the preferred return may result in a capital shift between partners.

\(^{57}\) If so, this could result in a capital shift among partners. The law concerning capital shifts in partnerships is not at all developed. The principal authority is the case of *Lehman v. Commissioner*, 19 T.C. 659 (1953).
h. Internal Rate Of Return Provisions.

Internal rate of return provisions are a special category of preferred return provisions. Few attorneys drafting internal rate of return provisions understand the mathematics of internal rate of return well. Many attorneys are adverse to computational issues. Clients and their financial analysts typically have a poor understanding of internal rate of return. Many advisors who believe that they are experienced in internal rate of return have little understanding.

The general concept of internal rate of return is that the internal rate of return is the discount rate at which the present value of positive cash flows and negative cash flows is equal. Internal rate of return, however, is considerably more complicated than this simple statement. Fully understanding internal rate of return requires understanding the nuances of a high order polynomial equation.

Internal rate of returns generally are considered for determining when the service partnership interest should begin to participate in profits from the project. The internal rate of return computations can be based on distributions to the capital partners or on the project-based internal rate of return.

Salviati, who fortunately has a doctorate from the California Institute of Technology in applied mathematics, considers, in addition to the issues for preferred returns:

- Nuances of solving high order polynomial equations. The expanded internal rate of return equation is a high order polynomial. This polynomial typically will have many solutions, most of which are complex numbers (imaginary numbers). The partnership agreement draftsman may wish to limit solutions relevant to the partnership agreement to the internal rate of return condition to positive real number interest rates. The draftsman may be more imaginative and wish to include complex number solutions to the internal rate of return equation. These complex number solutions can be determined using computational software. Excel will not find these solutions. Few partnership agreement draftsmen will wish to consider complex number solutions of the internal rate of return.

- The need for the partnership to eliminate complex number and negative real number solutions to the internal rate of return equation.

- Plots of net present value against discount rate. Salviati regularly undertakes plots of net present value to ensure that he understands the behavior of his internal rate of return hurdles. The plot expresses net present value as a function of discount rate. Net present value might be placed on the y-axis of Cartesian coor-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

dinates. Discount rate is on the x axis. A solution to the polynomial should exist wherever the graph crosses the x-axis. Examining this plot under reasonably expected scenarios can give the draftsman and the partners a better appreciation of how internal rate of return hurdles will operate.

- Descartes rule of signs. Descartes’ rule of signs determine the upper limit of the positive real number roots of a polynomial. The rule of signs also determines the upper limit of negative roots, but that is less useful for financial computations.

- Sturm’s Theorem. Sturm’s theorem determines the number of real roots of a polynomial within an interval. Sturm’s theorem can be used to determine the number of real solutions to the internal rate of return equation. While Sturm’s theorem can be applied by hand, it generally is easier to apply Sturm’s theorem using sophisticated computational computer software. Other computational algorithms also can be used to determine the number of real roots of a polynomial. Salviati regularly uses computational software to determine the possibility of multiple solutions to internal rate of return hurdles. Further discussion of Sturm’s theorem is beyond the scope of this Article. Other methods are also available for determining the number of positive roots of the internal rate of return equation.

- The Newton-Raphson iteration method. The Newton-Raphson iteration method is used to solve equations through successive approximation.

- Which solutions to the internal rate of return equation should be rejected. Solutions that involve increasing net present values for increasing discount rates should be rejected.

- What formula the partnership agreement should use in computing internal rate of return. The formula might be based on a 365/366-day computational year or a computational year of equal periods, with each cash flow assigned to a period. The periods might be days, weeks, months, quarters, semi-annual, or annual. The computations will lose texture (and perhaps invite manipulative behavior) as the length of the computational period increases. Salviati states a clear formula based on a 365/366-day year. This avoids the analytical compromises that are made when the partnership agreement selects computing the internal rate of return based on periods that are greater than one day and grouping all cash flows into a period.

- Which Excel function should Salviati use (IRR or XIRR), which version of Excel should Salviati specify, and how should Salviati
deal with software errors and limitations in Excel if Salviati were to use Microsoft Excel to compute internal rate of return. Salviati finds that use of the IRR function for partnership cash flows can result in sloppy and inappropriate computations, particularly when based for period of greater than one day, except where cash flows must occur on the last day of a period. The XIRR function in Excel usually provides a more accurate computation of internal rate of return than the IRR function. The use of the IRR function can encourage manipulating when distributions are made, particularly when the IRR functions uses longer periods. Methodology and results may differ among different versions of Microsoft Excel. Salviati considers the possibility that the version of Excel that he prefers may not be generally available in the future. Salviati describes precisely how the partnership should use Excel to calculate internal rate of return if the partnership agreement defines internal rate of return in terms of Excel. The partnership agreement may define preferred returns or internal rates of return in terms of Excel. (The author discourages this practice.) If so, the partnership agreement should be careful in defining precisely how the analyst should prepare the spreadsheet rather than merely waive Excel like a flag. Many contractual provisions give the analysts unreasonable discretion in applying the Excel functions. A partnership agreement that defines internal rate of return in terms of an Excel function risks interpretive questions. Under some circumstances of complex cash flows, XIRR can produce results that are materially wrong. The user also should be careful to convert an annually internal rate of return trigger into a periodic discount rate that is compounded more often than annually.

- What constraints limit a solution that Salviati wishes to consider (such as, does Salviati wish to exclude solutions where the net present value of cash flows is increasing for increasing values of the discount rate)?
- Should cash flows be assigned to notional dates or should the computations consider the date of which each cash flow occurs?
- Should internal rate of return computations be based on the capital partners’ returns or on the project’s returns?
- If partners’ return are based on the project return rate, should the computation of the return rate be based on the gross cost of the project or on the net cost of the project? What amounts should be capitalized for this purpose?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

• Are capital contributions made at the same time and, if not, how should this be taken into account in undertaking internal rate of return computations?

• How does the operation of squeeze-down provisions affect the computation of internal rate of return hurdles?

• What is the distribution percentage for an internal rate of return tier when there has been a shift in the ratio of capital contributions of the partners during the computation period?

• Is there a lock-out period during which the project cannot be sold or refinancing distributions made in order to ensure that the return to the cash investors is economically meaningful?

• Should the partner receiving a distributions measured by an internal rate of return be entitled to a minimum dollar profit under this tier?

• Does the internal rate of return tier only apply to distributions on sale and refinancing, but consider prior distributions of operating cash?

• Is the internal rate of return tier stated on a project by project basis or is it stated based on the return for the entire partnership?

• Is the internal rate of return tier based on operating distributions, distributions of cash from capital events, or both? How are expenses allocated as charges between the two categories?

Assume that a venture produces these cash flows from inception through year 10:

<table>
<thead>
<tr>
<th>Year</th>
<th>Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$(1,000,000.00)</td>
</tr>
<tr>
<td>1</td>
<td>$20,000.00</td>
</tr>
<tr>
<td>2</td>
<td>$40,000.00</td>
</tr>
<tr>
<td>3</td>
<td>$44,800.00</td>
</tr>
<tr>
<td>4</td>
<td>$50,176.00</td>
</tr>
<tr>
<td>5</td>
<td>$56,197.12</td>
</tr>
<tr>
<td>6</td>
<td>$62,940.77</td>
</tr>
<tr>
<td>7</td>
<td>$70,493.67</td>
</tr>
<tr>
<td>8</td>
<td>$78,952.91</td>
</tr>
<tr>
<td>9</td>
<td>$88,427.26</td>
</tr>
<tr>
<td>10</td>
<td>$1,099,038.53</td>
</tr>
</tbody>
</table>
This chart shows a plot of the net present values of cash flows at varying interest rates. The point at which the plot of net present values of cash flows crosses the x-axis is the internal rate of return:
Salviati regularly plots projected returns against discount rates so that he better can understand the economics of the internal rate of return and its effects on partnership distribution provisions.

Microsoft Excel finds only one solution when multiple real solutions exist. Excel may identify a solution that is economically inappropriate – or fail to identify a solution that is appropriate. Excel may fail when the first cash flow is zero or a positive number. Excel may fail to converge on a solution within the permitted 20 iterations. A complex cash distribution pattern could cause Excel to fail to find internal rate of return solutions. Merely instructing the accountants to use the IRR function does not provide adequate instructions to accountants for them to apply the IRR function adequately. The IRR function depends on how the user groups cash flows. Using long period groupings of cash flows (such as annual) can result in anomalous results. Clients and advisors often have poor appreciation of the intricacies of both internal rate of return and the Excel IRR and XIRR functions. A draftsman who is not experienced in calculating internal rate of return using Excel can have difficulty drafting internal rate of return provisions for partnership agreements that can be applied precisely. Drafting adequate internal rate of return provisions using XIRR or IRR requires precise specification that rarely is present in partnership agreements. It is not effective practice simply to say that internal rate of return will be calculated using the Excel IRR or XIRR functions. The precise application of these functions should be set forth in the agreement. Provisions based on internal rate of return should consider: When are contributions deemed made? When are distributions deemed made? What formula should computations use? What are the proper compounding conventions? What is the compounding
date? What is the compounding frequency? What convention is used for years or days between dates? How should the partnership agreement handle multiple positive real number solutions? How should the partnership agreement handle imaginary number solutions? Do lower-tier distributions apply in satisfying upper-tier triggers?

i. Other Common Issues Concerning Partnership Distributions.

This lists some common issues that Salviati considers in partnership distribution provisions:

- Definitions of relevant terms.
- Rank order of different classes of partnership interests with respect to preference of distributions, including normal operating distributions, distributions from capital events, distributions of cash from financings and refinancings, and distributions with respect to liquidation.
- How does the partnership allocate cash to different distribution pools?
- How does the partnership allocate expenses to different pools of cash for distribution?
- In what form does the partnership make distributions?
- When does the partnership agreement require distributions to be made?
- When does the partnership agreement deem distributions to be made for computational purposes?
- Who determines when the partnership makes distributions?
- Can the partnership arbitrarily determine not to make distributions?
- Who determines the amount of distributions?
- What does the partnership agreement require for the partnership to make distributions?
- What limitations and requirements does the partnership agreement impose on the amounts of partnership distributions?
- What limitations and restrictions on distributions may exist under state law?
- What limitations and restrictions on distributions may exist under loan documents or loan-related documents?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- What funds are available for partnership distributions?
- Can the partnership withhold distributions or are distributions mandatory?
- Can the partnership offset distributions to partners against partner obligations to the partnership?
- Can the partnership offset distributions against prior tax distributions?
- How are disputes concerning distributions handled?
- What happens if the partnership does not make distributions when required?
- What are the provisions of the partnership agreement regarding accrued but unpaid distributions?
- What effects do distributions in arrears have on current distributions?
- How does the partnership agreement compute preferred distributions?
- Does the partnership agreement provide for special distributions to pay taxes?
- Do distribution provisions cross the economics of several different partnerships?
- May the partnership enter into loan agreements or other contracts that limit or restrict distributions?
- When may the partnership make distributions on common interests by comparison to preferred distributions?
- What are operating distributions and liquidation distribution preferences?
- Does the partnership have a provision for sinking funds for retirement of any partnership interests?
- What are the partnership agreement provisions regarding redemption of interests, including priority of redemption payments?
- How does the partnership agreement allocate payments to a member among different classes of distribution?
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

- If there are returns computed on a deal by deal basis, how are unrealized investments valued (such as on the lower of a cost or market basis)?
- Do distribution provisions create adversity between managers and passive investors?
- In computing returns on a deal by deal basis, is there provision for impairments and write-offs and all fees and expenses accrued to date?
- Which partners economically bear the service partnership interest?
- Does the computation of profits for the service partnership interest cross investments?
- Does the computation of the profits for the service partnership interest cross partnerships? What tax concerns does this create?
- Is the service partnership interest computed on an after-tax basis?
- Are payments made on service partnership interest prior to recovery of full invested capital?
- Are profits for the service partnership interest paid prior to return of capital contributed for fees and expenses on the entire deal?
- Are profits for the service partnership interest paid prior to return of all capital invested in a particular investment?
- Is there a net asset value coverage test (“NAV coverage test”) before distributions of the profits for the service partnership interest?
- How are unrealized investments valued for purposes of the service partnership interest?
- Are profits for the service partnership interest determined on the basis of net profits or gross profits?
- Are there escrow accounts with significant reserves for profits for the service partnership interest?
- Are there events upon which the service partner will forfeit his service partnership interest?
- What are these events?
- What is the forfeiture mechanism?
- Who makes the determination that a forfeiture condition has occurred?
Some Comments On How To Compromise Drafting Partnership And LLC Agreements And Some Basic Issues In Drafting Real Estate Partnership And LLC Agreements

- What is the mechanism for disputing whether a forfeiture condition has occurred?
- What happens to a residual interest that the service partnership interest partner may have acquired for cash?
- Is cure for defaults by a service manager available?
- What provisions control clawbacks from managers for service partnership interests?
- Are there clawback provisions for service partnership interests with respect to distributions to the managing partner?
- If so, what is the tax treatment of the clawback for service partnership interests?
- What is the clawback period for service partnership interests? Does it extend beyond liquidation of the partnership?
- Are clawbacks for service partnership interests net of taxes paid by the partner? How are partner taxes calculated for this purpose?
- Is a time value of money factor applied to clawbacks for service partnership interests?
- Do service partners have joint and several liability for all clawbacks or is liability several?
- Is there a creditworthiness guarantee by a parent with respect to clawbacks for service partnership interests?
- Are there interim clawbacks for service partnership interests? What are the interim events?
- Are clawbacks for service partnership interests designed to that, when required, they will be fully and timely repaid?
- Are clawbacks for service partnership interests required on ethical or financial misconduct?
- Should the partnership agreement provide for escrow accounts with reserves to cover potential clawback liabilities of the managers?
- Are clawbacks for service partnership interests designed so that they will be repaid on a timely basis?
- What is the period for clawbacks from the managers for service partnership interests?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- How is the clawback calculated?
- When does the clawback occur?
- Is there sufficient security behind the clawback obligations?
- Are actual and potential clawback liabilities clearly disclosed to passive investors?
- Are clawback amounts net of taxes paid?
- Does the computation of clawbacks include consideration of loss carryforwards and carrybacks, the character of income, deductions attributable to state tax payments, ordinary deductions or losses resulting from clawback contribution or capital account shift, and any changes in tax laws.
- Is there provision from prompt return of tax distributions made to the managers.
- Does sufficient security stands behind the clawback obligation?
- Do passive investors have adequate power to enforce clawbacks?
- Can partnership distributions be clawed back by partnership creditors?

j. Squeeze-down Provisions on Default on Capital Contributions.

Salviati considers these common problems in drafting squeeze-down provisions:58

- What formula does the partnership agreement use to recompute percentage interests?
- What formula does the partnership agreement use to recompute capital accounts?
- What formula does the partnership agreement use to recompute invested capital?

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should adjustments be based on current values or on investment in the partnership?
- Should the formula take into account timing of capital contributions?
- Is the formula based on capital accounts?
- Will the formula work if capital accounts are negative?
- Is the formula based on unrecovered capital contributions?
- Will the formula work if all capital has been recovered?
- What are all of the provisions of the partnership agreement that the squeeze-down will affect?
- Does the formula provide for superdilution?
- Does the formula properly take into account promotional interests and partnership interests granted in consideration of the performance of services?
- Does the formula adequately take into account book-up capital account adjustments?
- Do all distribution and allocation tiers work in light of revisions on account of the squeeze-down provision?
- Does the formula consider when capital contributions were made to the partnership?
- Is the formula economically fair?
- Is the formula economically rational?
- Is the formula intended to create a penalty or a liquidated damages provision?
- Will a court enforce a penalty provision?\(^5\)
- Which state law will be applied to determine the enforceability of the dilution clause?
- Will a bankruptcy court enforce a penalty provision if a defaulting partner is in bankruptcy?

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Does the formula make numerical sense?
- Is the formula unambiguous?
- Will adjustments under the formula result in taxable capital shifts?
- Has the formula been modeled with realistic numbers?
- Has the formula been stress tested?
- What are the broader economic effects of the adjustment provision?
- Have the partnership accountants modeled these effects?
- How do adjustments affect the distribution waterfall?
- What are the tax effects of the adjustments?
- What effects will the adjustments have on tax-exempt partners?
- What are the effects of adjustments on obligations to make future capital contributions to the partnership?
- Can the partnership continue amicably after a capital contribution default and adjustment – or will the partnership arrangement be so thoroughly poisoned that partnership operations and relations will be disrupted?
- Should a buy-out of the defaulting partner’s partnership interest be considered as an alternative to an adjustment mechanism?

k. **Withholding Provisions.**

Partnership agreements may fail to address federal or state withholding on income allocated to partners or distributions distributed to partners. Withholding obligations may exceed the cash distributed to the partner. Salviati’s partnership agreement addresses sources of cash for withholding payments if the partnership may have a withholding obligation that exceeds the distribution to a partner. Salviati considers both federal and state withholding obligations. Salviati limits the partner to an action against the governmental agency (rather than the partnership) if the partner believes that withholding has been in excess of the amount required by law. An aggrieved partner otherwise may sue the partnership if he believes that the partnership has withheld excessively or inappropriately.

12. **Careless Allocations.**

The state of the art in drafting partnership allocations of partners’ distributive shares of income, gain, loss, deduction, or credit (or item thereof) is dismal.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Poorly drafted allocations can result in adverse audits. Partnership allocations often show signs of compromise. Advisors also often forget to consider the effects of phantom income that can result from partnership allocations.

The state of the art of the Internal Revenue Service in auditing partnership allocations of partners’ distributive shares of income, gain, loss, deduction, or credit (or item thereof) similarly is dismal. Some advisors wonder whether they should spend much time seeking to perfect partnership allocations if the Internal Revenue Service does not audit partnership allocations effectively. The Internal Revenue Service has shown little interest in partnership allocations since publishing regulations under Section 704.

Many partnerships have been saved from problems from Internal Revenue Service audits of partnership allocations only because the Internal Revenue Service has a poor record of training and performance in auditing partnership allocations. The performance of the Internal Revenue Service is so dismal in few areas. Few Internal Revenue Service auditors have deep expertise in the Section 704(b) area. The Internal Revenue Service has substantially ignored training and specialization in the area of partnership allocations. Many questionable allocations routinely fail to pass muster in Internal Revenue Service audit. The performance of the Internal Revenue Service in this area is so dismal that many draftsman appear to believe that the Internal Revenue Service routinely avoids intermediate or advanced allocation issues entirely, except in the case of partnerships identified with tax shelter transactions. Outside of identified tax shelter cases, the Internal Revenue Service generally has little interest in partnership allocations. Simplicio believes that practically anything goes in partnership allocations. Simplicio believes this his agreements have practical impunity from Internal Revenue Service audit attack on allocations on account of the Internal Revenue Service’s disinterest in partnership allocations.

Treasury has drafted extensive regulations under Section 704(b) setting forth rules of substantial economic effect for specific allocations of tax items. Few practitioners understand the nuances and deep structure of these rules. Many questions about aspects of the allocation regulations are unanswered. Additionally, the area of substantiality is in substantial confusion on account of the weakness of the regulations. The regulations apparently have failed to provide the Internal Revenue Service with an effective audit tool.

Comparatively few partnership agreements fully comply with the basic rules of economic effect. These rules require both (i) distribution of proceeds of

---

60 Treas. Reg. § 1.704-1.
61 Treas. Reg. § 1.704-1(b).
liquidation in accordance with capital accounts and (ii) partner deficit capital restoration at liquidation of the partnership.

Many partnerships follow the alternate test for economic effect\(^{62}\) rather than the basic test of economic effect.\(^ {63} \) These partnerships following the alternate

---

\(^{62}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d) (“(d) Alternate test for economic effect. If – (1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and (2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and (3) The partnership agreement contains a ‘qualified income offset,’ such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and (5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and (6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made (other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner’s capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain)’ under section 1.704-2 (f). For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a ‘qualified income offset’ if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

test for economic effect do not require deficit capital account restoration upon liquidation. Properly drafted, the allocations in the partnership agreements of these partnerships can work well. Salviati is careful to ensure that, under all circumstances, capital accounts accord with the economic plan at the liquidation of the partnership. Salviati otherwise may be embarrassed when the partnership distributes the proceeds of liquidation in accordance with positive capital account balances. Salviati has the partnership accountants model the allocations and test this model with a wide variety of scenarios to ensure that the allocations work properly. These scenarios include both anticipated scenarios and extreme scenarios that stress test the allocations.

It can be important for partnerships satisfying economic effect also to satisfy the fractions rule if the partnerships contain tax-exempt investors that qualify for the Section 514(c)(9) exception to debt financed income rules.

---

gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners’ interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(i) of this section are satisfied. . . .”.

65 See Treas. Reg. § 1.514(c)-2 (“. . . (b) Application of section 514(c)(9)(E), relating to debt-financed real property held by partnerships (1) In general. This section 1.514(c)-2 provides rules governing the application of section 514(c)(9)(E). To comply with section 514(c)(9)(E), the following two requirements must be met: (i) The fractions rule. The allocation of items to a partner that is a qualified organization cannot result in that partner having a percentage share of overall partnership income for any partnership taxable year greater than that partner’s fractions rule percentage (as defined in paragraph (c)(2) of this section). (ii) Substantial economic effect. Each partnership allocation must have substantial economic effect. However, allocations that cannot have economic effect must be deemed to be in accordance with the partners’ interests in the partnership pursuant to section 1.704-1(b)(4), or (if section 1.704-1(b)(4) does not provide a method for deeming the allocations to be in accordance with the partners’ interests in the partnership) must otherwise comply with the requirements of section 1.704-1(b)(4). Allocations attributable to nonrecourse liabilities or partner nonrecourse debt must comply with the requirements of section 1.704-2(e) or section 1.704-2(i). (2) Manner in which fractions rule is applied (i) In general. A partnership must satisfy the fractions rule both on a prospective basis and on an actual basis for each taxable year of the partnership, commencing with the first (footnote continued on the next page)
Many partnership agreements do not liquidate in accordance with capital account balances. Many partnerships use what many practitioners call “target allocations.” These allocations allocate items of income and loss so as to set up taxable year of the partnership in which the partnership holds debt-financed real property and has a qualified organization as a partner. Generally, a partnership does not qualify for the unrelated business income tax exception provided by section 514(c)(9)(A) for any taxable year of its existence unless it satisfies the fractions rule for every year the fractions rule applies. However, if an actual allocation described in paragraph (e)(4), (h), (j)(2), or (m)(1)(ii) of this section (regarding certain allocations that are disregarded or not taken into account for purposes of the fractions rule until an actual allocation is made) causes the partnership to violate the fractions rule, the partnership ordinarily is treated as violating the fractions rule only for the taxable year of the actual allocation and subsequent taxable years. For purposes of applying the fractions rule, the term PARTNERSHIP AGREEMENT is defined in accordance with section 1.704-1(b)(2)(ii)(h), and informal understandings are considered part of the partnership agreement in appropriate circumstances. See paragraph (k) of this section for rules relating to changes in the partners’ interests and de minimis exceptions to the fractions rule. (ii) Subsequent changes. A subsequent change to a partnership agreement that causes the partnership to violate the fractions rule ordinarily causes the partnership’s income to fail the exception provided by section 514(c)(9)(A) only for the taxable year of the change and subsequent taxable years. . . .”

66 Treas. Reg. § 1.704-2
67 For some other discussions of target allocations, see, e.g., New York State Bar Association, Tax Section, “Report on Partnership Target Allocations,” Report No. 1219, 2010 TNT 185-18 (Sept. 23, 2010); Amy S. Elliott, “IRS’ Silence on Targeted Allocations Doesn’t Mean Approval, Official Says,” 2012 TNT 216-1 (Nov. 7, 2012) (“Speaking on his own behalf at the American Institute of Certified Public Accountants Tax Division meeting in Washington, [Associate Chief Counsel Curtis] Wilson said, ‘Within parameters, I think targeteds either can work or . . . can come pretty close. But there are things outside those parameters that perhaps we wouldn’t look so kindly on. So I wouldn’t take any comfort from the fact that we haven’t questioned the more routine things.’”); Noel Brock, Targeted Partnership Allocations, Part I, The Tax Advisor (June 1, 2013); Noel Brock, Targeted Partnership Allocations, Part II, The Tax Advisor (July 1, 2013); Amy S. Elliott, “ABA Meeting: Treasury to Finalize Noncompensatory Partnership Option Regs, Official Says.” 2012 TNT 93-10 (May 14, 2012) (“[Attorney-Advisor Jennifer] Alexander said that while she agrees that figuring out what PIP means “is quite difficult,” she doesn’t expect any more guidance to be issued.”); letter, dated December 19, 2012, from Terence Floyd Cuff to the Honorable Mark
capital accounts (as adjusted) to correspond with the distribution scheme in liquidation: after the target allocations for the year, each partner’s capital account should equal the amount that the partner would receive if the partnership sold its assets for “book” value and distributed the proceeds in liquidation. Most advisors rely on these target allocations satisfying the rules of partners’ interests in the

partnership. Some advisors rely on the economic effect equivalence test to bless target allocations; however, that matter is much in controversy. Whether target allocations satisfy either partners’ interests in the partnership or the economic effect equivalence test is a matter that tax advisors debate.

The tax situation of target allocations is practically staggering. Many practitioners use target allocations routinely. Standards of practice, however, have not settled on how to draft target allocations. No commonly accepted “school solution” form has been generally approved for target allocations. Many target allocation provisions in common use are not very good.

A laundry list of issues burden target allocations. These are merely a few of those issues:

- Do target allocations have any tax effect at all, or does the tax law require real tax allocations in accordance with partners’ interests in the partnership without considering explicit target allocations?
- What adjustments to capital account need to be made for purposes of target allocations?

---

68 Treas. Reg. § 1.704-1(b)(3).
69 Treas. Reg. § 1.704-1(b)(2)(ii)(i) (“(i) Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. . . .”).
70 Treas. Reg. § 1.704-1(b)(3).
72 Treas. Reg. § 1.704-1(b)(3).
73 In a particular economic situation, it is possible that partners’ interests in the partnership necessarily produces a unique set of allocations. Otherwise, it is difficult to know how a court could apply partners’ interests in the partnership in the absence of allocations in the partnership agreement. If partners’ interests in the partnership produces a unique set of allocations in a particular situation, then it is not clear how target allocations can affect the allocations at all and still qualify under partners’ interests in the partnership.
74 Adjustments presumably should be made for shares of minimum gain and partner minimum gain. Target allocations should consider qualifying partner contribution obligations when appropriate. Advisors debate whether capital account

(footnote continued on the next page)
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

- Are target allocations subject to substantiality rules?75
- Are target allocations necessarily in accordance with partners’ interests in the partnership?76
- Do target allocations bless fill-up allocations for retiring partners?77

Adjustments should be made for partner contribution obligations that do not generally qualify under the Section 704(b) regulations. Partner or affiliate guarantees of partnership indebtedness might result in adjustments to adjusted capital accounts. Adjusted capital accounts perhaps should be adjusted on account of partner loans to the partnership. The tax world has not reached general agreement on all of the adjustments to adjusted capital accounts that need to be made for target allocations to work properly, if target can work at all.

75 The rules of substantiality expressly apply to allocations that have economic effect. Most advisors believe that target allocations do not have economic effect. Many advisors, however, believe that substantiality cannot be avoided by using allocation designed to qualify under partners’ interests in the partnership. The rules for applying substantiality to partners’ interests in the partnership have not been well developed.

76 Some advisors believe that target allocations, drafted properly, necessarily satisfy partners’ interests in the partnership. Other advisors do not share this belief. Some advisors believe that target allocations satisfy the economic effect equivalence test; most advisors dissent from this view. Most advisors concede that target allocations, drafted properly, frequently satisfy partners’ interests in the partnership.

77 A fill-up allocation to a retiring partner ensures that the retiring partner receives allocations, in his year of retirement, so that his capital account equals the amount that he will receive in retirement. This scheme often results in a substantial income or gain allocation to the retiring partner in his year of requirement. The retiring partner may be tax-indifferent to this gain or income allocation. The allocation increases the retiring partner’s capital tax basis in his partnership interest. The special allocation to the retiring partner does not affect the dollar amount that the retiring partner will receive in retirement. Some advisors question whether this fill-up allocation should be respected for tax purposes. For another discussion of stuffing allocations, see Andrew W. Needham, “The Problem With Stuffing Allocations,” Doc 2013-23314, 2013 TNT 223-9 (November 19, 2013); Brian E. Ladin, James M. Lowy & William S. Woods II, “Hedge Fund Stuffing Allocations: A Path Through the Maze,” 2008 TNT 228-34 (Nov. 24, 2008); letter, dated December 19, 2012, from Terence Floyd Cuff to the Honorable Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury, Doc. 2012-26417, (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- How should the draftsman draft a target allocation?
- Should target allocations be made from gross income and loss or from net income and loss?\(^\text{78}\)
- If the partnership makes target allocations from gross income and gross loss, how does the partnership determine precisely which items the tax law allocates to a partner?
- Should nonrecourse deductions, partner nonrecourse deductions, minimum gain chargeback allocations, and partner minimum gain chargeback allocations be excluded from target allocations?
- Can the partnership using target allocations specially allocate items?
- How does the target allocation provision work when the partnership has different pools of assets and a different economic deal with respect to each pool of assets?
- How does the target allocation provision work when the partnership agreement has different economic deals with respect to different events (such as operations, refinancing, sale of assets, and liquidation)?
- Can a partnership, consistent with partners’ interests in the partnership, \(^\text{79}\) specially allocate items of different character in different ways?

\(^{78}\) This issue is important when the partnership does not have sufficient net items for target allocations made on a net income or loss basis. Must the partnership then shift to allocations of gross items in order that capital accounts conform to the projected cash distribution scheme?

\(^{79}\) Treas. Reg. § 1.704-1(b)(3).
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

- Is a partnership using target allocations permitted to rebook assets in accordance with the Section 704(b) regulations?\(^{80}\)
- Is a partnership using target allocations required to rebook assets on permitted adjustment events in accordance with the Section 704(b) regulations?\(^{81}\)
- What is necessary for a provision to reverse Regulatory Allocations? What allocations should constitute Regulatory Allocations that should be reversed with operating income and loss allocations? Is this provision compatible with target allocations?
- How do target allocations deal with a retiring partner’s share of minimum gain in adjusting adjusted capital accounts?
- What is a retiring partner’s share of minimum gain?\(^{82}\)

---

80 The system of rebooking partnership assets is designed for partnerships that maintain capital accounts in accordance with the Section 704(b) regulations and that liquidate in accordance with capital accounts. Rebooking partnership assets would have no economic effect if the partnership does not liquidate in accordance with capital accounts. Similarly, there is no reason to believe that partners would have economic adversity when partnership assets are rebooked if the partnership does not liquidate in accordance with capital accounts. This partner adversity is an important component of keeping partners honest in the rebooking transaction. Rebooking partnership assets when using target allocations, if permitted, arguably shifts allocations from a partners’ interests in the partnership scheme to a Section 704(c) scheme. That, however, is a matter than can be debated. The regulations on partners’ interests in the partnership do not explicitly address rebooking partnership assets.

81 The concept of partners’ interests in the partnership arguably could require regularly rebooking partnership assets to fair market value on permitted rebooking events. Regular rebooking of partnership assets on permitted events may be so intertwined with the deep structure of Section 704(b) that partners’ interests in the partnership may require this regular rebooking in order properly to reflect partners’ interests in the partnership. This matter, however, is not clarified in the Section 704(b) regulations. The issue of rebooking assets under partners’ interests in the partnership is one of many unresolved issues under the Section 704(b) regulations.

82 See Treas. Reg. § 1.704–2(g) (“(g) Shares of partnership minimum gain. (1) Partner’s share of partnership minimum gain. Except as increased in paragraph (g)(3) of this section, a partner’s share of partnership minimum gain at the end of any partnership taxable year equals: (i) the sum of nonrecourse deductions allo-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does minimum gain of a retired partner shift to the continuing partners?
- Can the partnership satisfy the fractions rule?

cated to that partner (and to that partner’s predecessors’ in interest) up to that time and the distributions made to that partner (and to that partner’s predecessors’ in interest) up to that time of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain (see paragraph (h)(1) of this section); minus (ii) the sum of that partner’s (and that partner’s predecessors’ in interest) aggregate share of the net decreases in partnership minimum gain plus their aggregate share of decreases resulting from revaluations of partnership property subject to one or more partnership nonrecourse liabilities. For purposes of section 1.704-1(b)(2)(ii)(d), a partner’s share of partnership minimum gain is added to the limited dollar amount, if any, of the deficit balance in the partner’s capital account that the partner is obligated to restore.

(2) Partner’s share of the net decrease in partnership minimum gain. A partner’s share of the net decrease in partnership minimum gain is the amount of the total net decrease multiplied by the partner’s percentage share of the partnership’s minimum gain at the end of the immediately preceding taxable year. A partner’s share of any decrease in partnership minimum gain resulting from a revaluation of partnership property equals the increase in the partner’s capital account attributable to the revaluation to the extent the reduction in minimum gain is caused by the revaluation.

(3) Conversions of recourse or partner nonrecourse debt into nonrecourse debt. A partner’s share of partnership minimum gain is increased to the extent provided in this paragraph (g)(3) if a recourse or partner nonrecourse liability becomes partially or wholly nonrecourse. If a recourse liability becomes a nonrecourse liability, a partner has a share of the partnership’s minimum gain that results from the conversion equal to the partner’s deficit capital account (determined under section 1.704-1(b)(2)(iv)) to the extent the partner no longer bears the economic burden for the entire deficit capital account as a result of the conversion. For purposes of the preceding sentence, the determination of the extent to which a partner bears the economic burden for a deficit capital account is made by determining the consequences to the partner in the case of a complete liquidation of the partnership immediately after the conversion applying the rules described in section 1.704-1(b)(2)(iii)(c) that deem the value of partnership property to equal its basis, taking into account section 7701(g) in the case of property that secures nonrecourse indebtedness. If a partner nonrecourse debt becomes a nonrecourse liability, the partner’s share of partnership minimum gain is increased to the extent the partner is not subject to the minimum gain chargeback requirement under paragraph (i)(4) of this section.”
Further development of these issues is beyond the scope of the current Article.83 Perfecting a target allocation clause is time consuming. That clause may end up not working at all. The law is not clear on whether target allocation clauses can affect how the tax law allocates income and loss when the partnership agreement uses partners’ interests in the partnership.84

Other partnerships may rely on some other scheme of partnership allocations of partners’ distributive shares of income, gain, loss, deduction, or credit or perhaps do not allocate these items at all. These partnerships implicitly rely on partners’ interests in the partnership.85 A simple allocation can simply say that: “A partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) will be determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances).” That is not necessarily such a bad thing to rely on.

The many partnership agreements using target allocations may well rely on partners’ interests in the partnership.86 A partnership agreement with no tax allocations at all may well fare just as well as a partnership agreement with exquisitely drafted target allocations. In any event, all of these partnerships likely rely on partners’ interests in the partnership. The problem is that the rules of partners’ interests in the partnership often are not well defined. The partnership accountants may be unsure in many situations how to complete the partnership tax returns.

Further issues of partners’ interests in the partnership87 and drafting target allocation provisions are discussed later in this Article.

13. Failure to Deal Adequately With Special Considerations of Service Partners.

The issuance of a partnership interest for service provides many opportunities for Simplicio to draft a compromised partnership agreement. The introduction of a service partner creates both economic and tax issues. The popularity of

---

83 These issues are discussed in letter, dated December 19, 2012, from Terrence Floyd Cuff to The Honorable Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury, Doc. 2012-26417, 2012 TNT 246-15 (December 19, 2012).
84 Treas. Reg. § 1.704-1(b)(3).
85 Treas. Reg. § 1.704-1(b)(3).
86 Treas. Reg. § 1.704-1(b)(3).
87 Treas. Reg. § 1.704-1(b)(3).
“carried interests” in a wide variety of funds has particularly caused the expansion of service partner issues. Salviati considers these issues, among others, in drafting a partnership agreement that includes service partners:

- What are the restrictions under the partnership agreement on who may receive a partnership interest for services?
- What approval process is required?
- Are service interests transferrable?
- What are the tax consequences to the service partner and the partnership of the issuance of a compensatory partnership interest?
- To what extent should currently drafted partnership agreements reflect principles that are reflected in REG-105346-03 (setting forth proposed regulations concerning partnership interests received for services)?
- Is the compensatory partnership interest “property” for purposes of Section 83?
- Should the partnership make a liquidation value election\(^ {88} \) for service partners?

\(^ {88} \) See Prop. Treas. Reg. § 1.83-3(l) (“(l) Special rules for the transfer of a partnership interest. (1) Subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter), a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the Federal Register if the following conditions are satisfied: (i) The partnership must prepare a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the partnership for the taxable year that includes the effective date of the election. (ii) Except as provided in paragraph (l)(1)(ii) of this section, the partnership agreement must contain provisions that are legally binding on all of the partners stating that – (A) The partnership is authorized and di-

\((\text{footnote continued on the next page})\)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does the service partner’s interest give the service partner a right to a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership?
- Should the service partner make a Section 83(b) election?
- When must this election be made? [89]

---

[89] See Treas. Reg. § 1.83-2(a), (b), (c) (“(a) In general. If property is transferred (within the meaning of section 1.83-3(a)) in connection with the performance of services, the person performing such services may elect to include in gross income under section 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse re- (footnote continued on the next page)
Does a Section 83(b) election apply to a compensatory partnership interest?^{90}

striction, as defined in section 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election as provided for in this section. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in section 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in section 1.83-3(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b). If property for which a section 83(b) election is in effect is forfeited while substantially nonvested, such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of – (1) The amount paid (if any) for such property, over, (2) The amount realized (if any) upon such forfeiture. If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss. A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the two immediately preceding sentences. (b) Time for making election. Except as provided in the following sentence, the election referred to in paragraph (a) of this section shall be filed not later than 30 days after the date the property was transferred (or, if later, January 29, 1970) and may be filed prior to the date of transfer. Any statement filed before February 15, 1970, which was amended not later than February 16, 1970, in order to make it conform to the requirements of paragraph (e) of this section, shall be deemed a proper election under section 83(b). (c) Manner of making election. The election referred to in paragraph (a) of this section is made by filing one copy of a written statement with the internal revenue office with whom the person who performed the services files his return. In addition, one copy of statement shall be submitted with this income tax return for the taxable year in which such property was transferred.”

^{90} See, generally, REG-105346-03; 70 Fed. Reg. 29675-29683 (May 24, 2005) (proposed regulations regarding compensatory partnership interests for services); (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Is the compensatory partnership interest a restricted interest (non-transferable and subject to a substantial risk of forfeiture)?
- Is the service partner receiving a capital interest or a profits partnership interest?
- Does the service partner participate in unrealized appreciation in partnership assets (including receivables, work in progress, workforce in place, and goodwill) existing at the admission of the service partner?
- Is the service partner taxable on his admission to the partnership?
- Does the profits interest relate to a substantially certain and predictable stream of income from partnership assets (such as income from high-quality debt securities or a high-quality net lease)?
- Will the service partner dispose of his profits interest within two years of grant?
- Can the profits interest be a retroactive interest in operating profits for the past partnership year?
- Can the profits interest be a retroactive interest in gain for the past partnership year?
- Is the profits interest a limited partnership interest in a “publicly traded partnership”?
- If the compensatory partnership interest is taxable to the recipient, how does the partnership agreement measure the fair market value of the interest?
- How is the service partnership interest structured so that it will have no interest in pre-admission appreciation?
- Will the service partner participate in profits before his admission to the partnership?
- Does the partnership have compensatory options? ¹¹


SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- What will the tax effects of the compensatory options be?
- How will the compensatory options affect how the partnership agreement is drafted?
- Will the service partner participate in operating cash distributions from dollar 1?
- Would the service partner participate in proceeds of the sale of partnership assets if the partnership were not yet in liquidation?
- Does the service partner participate in proceeds of partnership refinancings?
- When should the partnership take any deduction related to a compensatory partnership interest?
- To whom should this deduction be allocated?
- What is the proper capital account of the service provider?
- Is the partnership interest substantially vested for purposes of Section 83?
- If not, what will the tax consequences of substantial vesting be?
- How should this affect the drafting of the partnership agreement?
- Will the holder of a restricted partnership interest be treated as a partner for tax purposes?
- To what extent will this depend on making a Section 83(b) election?
- How is the partnership’s deduction with respect to taxable compensatory interests allocated among the partners?
- How will the partnership deal with capital account effects of any taxability of the service partner?
- How should the partnership agreement be drafted to take into account factor discussed in the 2005 proposed and withdrawn regulations on receipt of a partnership interest for services?
- Should the partnership agreement contain a contingent liquidation value election?

(f)(1), (5)(iv), (h)(2), (s), (b)(4)(ix), (x), (5), Example 31, 32, 33, 34, 35; Treas. Reg. § 1.721-1; Treas. Reg. § 1.761-3.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• How does the partnership deal with option holders and other partners with respect to liquidation value elections under the proposed regulations?
• Should both current and future partners be required to make liquidating value elections?
• Should this requirement be contingent?
• Precisely what contingency should be used?
• Is the partnership interest subject to a substantial risk of forfeiture?
• Is the service partner’s interest subject to a substantial risk of forfeiture?
• If so, what are the consequences of forfeiture (with and without a Section 83 election)?
• Should the partnership agreement make conditional forfeiture allocations?
• What should the conditions be?
• Can forfeiture allocations be made effectively if the partnership has target allocations?
• What is the effect of an unvested interest on partnership income and loss allocations?
• How do restricted interests or outstanding partnership options affect revaluations of assets and redeterminations of partner capital accounts?
• What is the effect of noncompensatory options on revaluation of assets and redetermination of capital accounts.
• How is the service partnership interest handled in connection with drag-along and tag-along rights?
• How does the service partnership interest affect dilution provisions?
• Does the service partner particulate in income from temporary investment of capital contributions?
• Are profits from the service partnership interest paid on recapitalizations?
• How should a target allocation provision deal with retroactive commencement date of a service partnership interest?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• How should clawback provisions for service partnership interests be structured?
• How should clawback provisions for service partnership interests be structured when the economics of the partnership interests cross multiple projects?
• How should clawback provisions for service partnership interests be structured when the economics of the partnership interests cross multiple partnerships?
• How does the existence of service partnership interests affect drafting a squeeze-down provision?
• Is the service partnership interest calculated on the basis of net profits or gross profits?
• Which partners economically bear the service partnership interest?
• Does the computation of profits for the service partnership interest cross investments?
• Does the computation of the profits for the service partnership interest cross partnerships? What tax concerns does this create?
• Is the service partnership interest computed on an after-tax basis?
• Are payments made on service partnership interest prior to recovery of full invested capital?
• Are profits for the service partnership interest paid prior to return of capital contributed for fees and expenses on the entire deal?
• Are profits for the service partnership interest paid prior to return of all capital invested in a particular investment?
• Is there a net asset value coverage test (“NAV coverage test”) before distributions of the profits for the service partnership interest?
• How are unrealized investments valued for purposes of the service partnership interest?
• Are there escrow accounts with significant reserves for profits for the service partnership interest?
• Are there events upon which the service partner will forfeit his service partnership interest?
• What are these events?
• What is the forfeiture mechanism?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Who makes the determination that a forfeiture condition has occurred?
- What is the mechanism for disputing whether a forfeiture condition has occurred?
- What happens to a residual interest that the service partnership interest partner may have acquired for cash?
- Is cure for defaults by a service manager available?
- What provisions control clawbacks from managers for service partnership interests?
- Are there clawback provisions for service partnership interests with respect to distributions to the managing partner?
- If so, what is the tax treatment of the clawback for service partnership interests?
- What is the clawback period for service partnership interests? Does it extend beyond liquidation of the partnership?
- Are clawbacks for service partnership interests net of taxes paid by the partner? How are partner taxes calculated for this purpose?
- Is a time value of money factor applied to clawbacks for service partnership interests?
- Do service partners have joint and several liability for all clawbacks or is liability several?
- Is there a creditworthiness guarantee by a parent with respect to clawbacks for service partnership interests?
- Are there interim clawbacks for service partnership interests? What are the interim events?
- Are clawbacks for service partnership interests designed to that, when required, they will be fully and timely repaid?
- Are clawbacks for service partnership interests required on ethical or financial misconduct?
- Should the partnership agreement provide for escrow accounts with reserves to cover potential clawback liabilities of the managers?
- Are clawbacks for service partnership interests designed so that they will be repaid on a timely basis?
• What is the period for clawbacks from the managers for service partnership interests?
• How is the clawback calculated?
• When does the clawback occur?
• Is there sufficient security behind the clawback obligations?
• Are actual and potential clawback liabilities clearly disclosed to passive investors?
• Does the computation of clawbacks include consideration of loss carryforwards and carrybacks, the character of income, deductions attributable to state tax payments, ordinary deductions or losses resulting from clawback contribution or capital account shift, and any changes in tax laws?
• Does sufficient security stand behind the clawback obligation?
• Do passive investors have adequate power to enforce clawbacks?
• Does the tax protection indemnification formula consider the possibility of changes in the law related to service partnership interests?
• Are profits from the service partnership interest paid on recapitalizations?
• Are there clear triggers on clawbacks?
• What are the tax consequences if a purported partner holds only a right to a guaranteed payment as consideration for his services?


The formation of a partnership provides many opportunities to compromise the partnership agreement under the disguised sale rules of Section 704(c)(2)(B) and Section 707(a)(2)(B) and Section 737. Simplicio will ignore these issues.  

---

92 This was written prior to new proposed regulations on disguised sales. See REG-119305-11; 79 F.R. 4826-4839 (January 30, 2014) (“Explanation of Provisions ¶ 1. Debt-Financed Distributions ¶ Section 1.707-3 of the existing regulations generally provides that a transfer of property by a partner to a partnership followed by a transfer of money or other consideration from the partnership to the (footnote continued on the next page)
partner will be treated as a sale of property by the partner to the partnership if, based on all the facts and circumstances, the transfer of money or other consideration would not have been made but for the transfer of the property and, for non-simultaneous transfers, the subsequent transfer is not dependent on the entrepreneurial risks of the partnership. Notwithstanding this general rule, the existing regulations provide several exceptions. ¶ One such exception in § 1.707-5(b) of the existing regulations generally provides that a distribution of money to a partner is not taken into account for purposes of § 1.707-3 to the extent the distribution is traceable to a partnership borrowing and the amount of the distribution does not exceed the partner’s allocable share of the liability incurred to fund the distribution (the ‘debt-financed distribution exception’). Under a special rule in the existing regulations, if a partnership transfers to more than one partner pursuant to a plan all or a portion of the proceeds of one or more liabilities, the debt-financed distribution exception is applied by treating all of the liabilities incurred pursuant to the plan as one liability. Thus, partners who are allocated shares of multiple liabilities are treated as being allocated a share of a single liability, to which any distributee partner’s distribution of debt proceeds relates, rather than a share of each separate liability. ¶ To illustrate the application of this rule, the proposed regulations add an example to the existing regulations to demonstrate that if more than one partner receives all or a portion of the debt proceeds of multiple liabilities that are treated as a single liability under the special rule, the debt proceeds will not be treated as consideration in a disguised sale to the extent of the partner’s allocable share of the single liability. ¶ In addition, the IRS and the Treasury Department are aware that there is uncertainty as to whether, for purposes of § 1.707-5(b)(2), the amount of money transferred to a partner that is traceable to a partnership liability is reduced by any portion of such amount that is also excluded from disguised sale treatment under one or more of the exceptions in § 1.707-4 (for example, because the transfer of money is also properly treated as a reasonable guaranteed payment). The IRS and the Treasury Department believe that the treatment of a transfer should first be determined under the debt-financed distribution exception, and any amount not excluded from § 1.707-3 under the debt-financed distribution exception should be tested to see if such amount would be excluded from § 1.707-3 under a different exception in § 1.707-4. This ordering rule ensures that the application of one of the exceptions in § 1.707-4 does not minimize the application of the debt-financed distribution exception. ¶ 2. Preformation Expenditures ¶ Section 1.707-4(d) of the existing regulations provides an additional exception for reimbursements of preformation expenditures to the general rule in § 1.707-3. Under § 1.707-4(d), transfers to reimburse a partner for certain capital expenditures and costs incurred are not treated as part of a sale of property under § 1.707-3 (the ‘exception for preformation capital expenditures’).

(footnote continued on the next page)
The proposed regulations amend the exception for preformation capital expenditures to address three issues. First, the proposed regulations provide how the exception for preformation capital expenditures applies in the case of multiple property transfers. The exception for preformation capital expenditures generally applies only to the extent that ‘the reimbursed capital expenditures do not exceed 20 percent of the fair market value of such property at the time of the contribution.’ This fair market value limitation, however, does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner’s adjusted basis in the contributed property at the time of the contribution. The references to ‘such property’ and ‘contributed property’ in § 1.707-4(d) are intended to refer to the single property for which the expenditures were made. Accordingly, in the case of multiple property contributions, the proposed regulations provide that the determination of whether the fair market value limitation and the exception to the fair market value limitation apply to reimbursements of capital expenditures is made separately for each property that qualifies for the exception. ¶ Second, the proposed regulations clarify the scope of the term ‘capital expenditures’ for purposes of §§ 1.707-4 and 1.707-5. For purposes of §§ 1.707-4 and 1.707-5, the term ‘capital expenditures’ has the same meaning as the term ‘capital expenditures’ has under the Code and applicable regulations, except that it includes capital expenditures taxpayers elect to deduct, and does not include deductible expenses taxpayers elect to treat as capital expenditures. The IRS and the Treasury Department are aware that taxpayers are uncertain whether the term capital expenditures includes only expenditures that are required to be capitalized under the Code. The purpose of the exception for preformation capital expenditures is to permit a partnership to reimburse a contributing partner for expenditures incurred with respect to contributed property. The IRS and the Treasury Department considered whether a contributing partner’s capital expenditures for this purpose should be reduced by the benefit of the tax deduction the contributing partner received prior to contribution of the property either because the capital expenditure was currently deductible by the contributing partner or recovered through amortization or depreciation deductions. The proposed regulations, however, do not adopt such an approach because the approach would be too burdensome to administer. ¶ Finally, the proposed regulations provide a rule coordinating the exception for preformation capital expenditures and the rules regarding liabilities traceable to capital expenditures. Section 1.707-5 provides special rules for disguised sales relating to liabilities assumed or taken subject to by a partnership. Under § 1.707-5(a)(1) of the existing regulations, a partnership’s assumption of or taking property subject to a qualified liability in connection with a partner’s transfer of property to the partnership is treated as a transfer of consideration to the partner only if the property transfer is otherwise treated as part of a sale. A liability constitutes a (footnote continued on the next page)
qualified liability of the partner to the extent the liability meets one of the four definitions of qualified liabilities under § 1.707-5(a)(6). One of the enumerated qualified liabilities is a liability that is allocable under the rules of § 1.163-8T to capital expenditures with respect to the property transferred to the partnership (the ‘capital expenditure qualified liability’). ¶ The IRS and the Treasury Department are aware that taxpayers are uncertain about whether a partner may qualify under the exception for preformation capital expenditures if those expenditures were funded with a capital expenditure qualified liability. For example, taxpayers are uncertain about whether a partner can finance its capital expenditures through a borrowing that is exempted as a qualified liability and can also be reimbursed for those expenditures without triggering sale treatment. The IRS and the Treasury Department believe that the exception for preformation capital expenditures applies only to the extent the distribution is in reimbursement of such expenditures. Thus, the proposed regulations provide that to the extent a partner funded a capital expenditure through a borrowing and economic responsibility for that borrowing has shifted to another partner, the exception for preformation capital expenditures should not apply because there is no outlay by the partner to reimburse. ¶ 3. Qualified Liabilities in a Trade or Business ¶ As previously mentioned, the existing regulations generally exclude qualified liabilities from disguised sale treatment. The legislative history of section 707(a)(2)(B) with respect to liabilities provides that Congress was ‘concerned with transactions that attempt to disguise a sale of property and not with non-abusive transactions that reflect the various economic contributions of the partners. . . . For example . . . the transaction will be treated as a sale or exchange of property . . . to the extent the partner has received a loan related to the property in anticipation of the transaction and responsibility for repayment of the loan is transferred to the other partners.’ See H.R. Rep. No. 432, pt. 2, 98th Cong. 2nd Sess. 1216, 1220-1221 (1984). ¶ The existing regulations under § 1.707-5(a)(6) provide four types of liabilities that are qualified liabilities. In addition to the capital expenditure qualified liabilities discussed previously, the existing regulations include as a qualified liability a liability incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held, but only if all of the assets that are material to that trade or business are transferred to the partnership (‘ordinary course qualified liability’). There is no requirement that these two types of liabilities encumber the transferred property to be treated as qualified liabilities. ¶ The remaining two types of qualified liabilities are liabilities incurred more than two years before the transfer (or written agreement to transfer), and liabilities incurred within two years of the transfer (or written agreement to transfer) but not in anticipation of the transfer. Liabilities incurred by a partner within two years of the transfer, other than capital expenditure and ordinary course qualified liabilities, are presumed to be incurred
in anticipation of the transfer unless the facts and circumstances clearly establish otherwise. With respect to both of these types of qualified liabilities, there is a requirement that the liability encumber the transferred property. ¶ The IRS and the Treasury Department believe the requirement that the liability encumber the transferred property is not necessary to carry out the purposes of section 707(a)(2)(B) when a liability was incurred in connection with the conduct of a trade or business, provided the liability was not incurred in anticipation of the transfer and all of the assets material to that trade or business are transferred to the partnership. Accordingly, the proposed regulations add an additional definition of qualified liability to account for this type of liability. As under the existing regulations regarding liabilities other than capital expenditure and ordinary course qualified liabilities, if the partner incurred the liability within two years of the transfer of assets to the partnership, (i) the liability is presumed under § 1.707-5(a)(7)(i) to have been incurred in anticipation of the transfer unless the facts and circumstances clearly establish that the liability was not incurred in anticipation of the transfer, and (ii) the treatment of the liability as a qualified liability under the new definition must be disclosed to the IRS under § 1.707-8. ¶ 4. Anticipated Reduction ¶ Under the existing regulations, for purposes of the rules under section 707, a partner’s share of a liability assumed or taken subject to by a partnership is determined by taking into account certain subsequent reductions in the partner’s share of the liability. Specifically, a subsequent reduction in a partner’s share of a liability is taken into account if (i) at the time that the partnership incurs, assumes, or takes property subject to the liability, it is anticipated that the partner’s share of the liability will be subsequently reduced; and (ii) the reduction is part of a plan that has as one of its principal purposes minimizing the extent to which the distribution or assumption of, or taking property subject to, the liability is treated as part of a sale (the ‘anticipated reduction rule’). The IRS and the Treasury Department are aware that there is uncertainty as to when a reduction is anticipatory because it is generally anticipated that all liabilities will be repaid. Consistent with the overall approach of the existing regulations under section 707, the IRS and the Treasury Department believe that a reduction that is subject to the entrepreneurial risks of partnership operations is not an anticipated reduction, and the proposed regulations adopt this approach. ¶ In addition, the proposed regulations provide that if within two years of the partnership incurring, assuming, or taking property subject to the liability, a partner’s share of the liability is reduced due to a decrease in the partner’s or a related person’s net value (as described in Part 8.a of the Explanation of Provisions section of this preamble), then the reduction will be presumed to be anticipated, unless the facts and circumstances clearly establish that the decrease in the net value was not anticipated. Any such reduction must be disclosed in accordance with § 1.707-8. ¶ 5. Tiered Partnerships ¶ The existing (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Regulations in § 1.707-5(e), and § 1.707-6(b) by applying rules similar to § 1.707-5(e), currently provide only a limited tiered-partnership rule for cases in which a partnership succeeds to a liability of another partnership. Under those rules, if a lower-tier partnership succeeds to a liability of an upper-tier partnership, the liability in the lower-tier partnership retains the same characterization as either a qualified or a nonqualified liability that it had as a liability of the upper-tier partnership. Similarly, if an upper-tier partnership succeeds to a liability of a lower-tier partnership, the liability in the upper-tier partnership retains the same characterization as either a qualified or a nonqualified liability that it had as a liability of the lower-tier partnership that incurred the liability. Moreover, the existing regulations provide that a similar rule applies to other related party transactions involving liabilities to the extent provided by guidance in the Internal Revenue Bulletin. See, for example, Rev. Rul. 2000-44, 2000-2 CB 336. ¶ The proposed regulations add additional rules regarding tiered partnerships. First, the proposed regulations clarify that the debt-financed distribution exception applies in a tiered partnership setting. Second, the proposed regulations provide rules regarding the characterization of liabilities attributable to a contributed partnership interest. Section 752(d) provides that in the case of a sale or exchange of an interest in a partnership, liabilities shall be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships. Accordingly, a partner that contributes an interest in a partnership (lower-tier partnership) to another partnership (upper-tier partnership) must take into account its share of liabilities from the lower-tier partnership in applying the rules under § 1.707-5. The IRS and the Treasury Department believe it is appropriate to treat the lower-tier partnership as an aggregate for purposes of determining whether the upper-tier partnership’s share of the liabilities of the lower-tier partnership are qualified liabilities. Thus, these proposed regulations provide that a contributing partner’s share of liabilities from a lower-tier partnership are treated as qualified liabilities to the extent the liability would be a qualified liability had the liability been assumed or taken subject to by the upper-tier partnership in connection with a transfer of all of the lower-tier partnership’s property to the upper-tier partnership by the lower-tier partnership. ¶ 6. Treatment of Liabilities in Assets-Over Merger ¶ 1.752-1(f) provides for netting of increases and decreases in partnership liabilities associated with a merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of a merger under section 752. The IRS and the Treasury Department believe that similar netting rules should apply with respect to the disguised sale rules and, accordingly, the proposed regulations extend the principles of § 1.752-1(f) to determine the effect of the merger under the dis-

(footnote continued on the next page)
Simplicio can compromise the partnership under disguised sale rules in these situations:

- Contributions of property by one partner and a distribution of cash or property to the partner within two years before or after the contribution of property.
- Contributions of property securing liabilities.
- Contributions of property by a partner, with the partnership assuming unsecured liabilities of the partner.
- Distributions of proceeds of borrowing to the partner within two years after a contribution of property by the partner.

 disguised sale rules. ¶ 7. Disguised Sales of Property by a Partnership to a Partner ¶

For disguised sales of property by a partnership to a partner, the existing regulations under § 1.707-6 provide that rules similar to those in § 1.707-5 (for disguised sales of property by a partner to a partnership) apply to determine the extent to which an assumption of or taking property subject to a liability by a partner, in connection with a transfer of property by a partnership, is considered part of a sale. More specifically, the existing regulations provide that if the partner assumes or takes property subject to a liability that is not a qualified liability, the amount treated as consideration transferred to the partnership is the amount that the liability assumed or taken subject to by the partner exceeds the partner’s share of that liability immediately before the transfer. Thus, if a transferee partner had a 100 percent share of a liability immediately before a transfer in which the transferee partner assumed the liability, then no sale is treated as occurring between the partnership and the partner with respect to the liability assumption, irrespective of the period of time during which the partnership liability is outstanding and the period of time in which the partnership liability is allocated to the partner. ¶

The IRS and the Treasury Department are studying these rules and believe it may be inappropriate to take into account a transferee partner’s share of a partnership liability immediately prior to a distribution if the transferee partner did not have economic exposure with respect to the partnership liability for a meaningful period of time before appreciated property is distributed to that partner subject to the liability. Thus, the IRS and the Treasury Department are considering, and request comments on, whether the rules under § 1.707-6 should be amended to provide that a transferee partner’s share of an assumed liability immediately before a distribution is taken into account for purposes of determining the consideration transferred to the partnership only to the extent of the partner’s lowest share of the liability within some meaningful period of time, for example, 12 months. . . .")
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Contributions of property by a partner followed by distributions to the contributing partner within seven years.
- Leveraged distributions of cash to a property-contributing partner where the partner has undertaken tax-oriented guarantees or indemnifications of partnership debt.

a. Canal Corporation.

In Canal Corporation v. Commissioner,93 a transaction that has acquired extensive publicity in the tax press, the Tax Court questioned the validity of tax-

93 135 T.C. 199 (2010). Cf. Southgate Master Fund LLC v. United States, 651 F. Supp.2d 596 (N.D. Tex. 2009), aff’d., 659 F.3d 466 (5th Cir. 2011). ILM 201324013 (March 14, 2013). Note that, since this article was written, Treasury and the Internal Revenue Service have published proposed regulations concerning “bottom guarantees.” See REG-119305-11; 79 F.R. 4826-4839 (January 30, 2014) (“The existing regulations under section 1.752-2 provide that a partner’s share of a recourse partnership liability equals the portion of the liability, if any, for which the partner or related person bears the economic risk of loss. A partner generally bears the economic risk of loss for a partnership liability to the extent the partner, or a related person, would be obligated to make a payment if the partnership’s assets were worthless and the liability became due and payable. Subject to an anti-abuse rule and the disregarded entity net value requirement of § 1.752-2(k), § 1.752-2(b)(6) assumes that all partners and related persons will actually satisfy their payment obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation (the ‘satisfaction presumption’). Thus, for purposes of allocating partnership liabilities, § 1.752-2 adopts an ultimate liability test under a worst-case scenario. Under this test, the regulations would generally allocate an otherwise nonrecourse liability of the partnership to a partner that guarantees the liability even if the lender and the partnership reasonably anticipate that the partnership will be able to satisfy the liability with either partnership profits or capital. ¶ The IRS and the Treasury Department have considered whether the approach of the existing regulations under § 1.752-2 is appropriate given that, in most cases, a partnership will satisfy its liabilities with partnership profits, the partnership’s assets do not become worthless, and the payment obligations of partners or related persons are not called upon. The IRS and the Treasury Department are concerned that some partners or related persons have entered into payment obligations that are not commercial solely to achieve an allocation of a partnership liability to such partner. The IRS and the Treasury Department believe that section 79 of the Tax Reform Act of 1984 (Public Law 98-369), which overruled the decision in Raphan v. United States, 3 Cl. Ct. 457 (1983) (holding that a guarantee by a general partner of an otherwise non-
The recourse liability of the partnership did not require the partner to be treated as personally liable for that debt, and directed the Treasury Department to prescribe regulations under section 752 relating to the treatment of guarantees and other payment obligations, was intended to ensure that bona fide, commercial payment obligations would be given effect under section 752. Accordingly, the proposed regulations provide a rule that obligations to make a payment with respect to a partnership liability (excluding those imposed by state law) will not be recognized for purposes of section 752 unless certain factors are present. These factors, if satisfied, are intended to establish that the terms of the payment obligation are commercially reasonable and are not designed solely to obtain tax benefits. Specifically, the rule requires a partner or related person to maintain a commercially reasonable net worth during the term of the payment obligation or be subject to commercially reasonable restrictions on asset transfers for inadequate consideration. In addition, the partner or related person must provide commercially reasonable documentation regarding its financial condition and receive arm’s length consideration for assuming the payment obligation. The rule also requires that the payment obligation’s term must not end prior to the term of the partnership liability and that the primary obligor or any other obligor must not be required to hold money or other liquid assets in an amount that exceeds the reasonable needs of such obligor. The rule would also prevent certain so-called ‘bottom-dollar’ guarantees from being recognized for purposes of section 752. Moreover, the IRS and the Treasury Department are concerned that some partners or related persons might attempt to use certain structures or arrangements to circumvent the rules included in these proposed regulations with respect to bottom-dollar guarantees. For example, a financial intermediary might artificially convert a single mortgage loan into senior and junior tranches using a wrap-around mortgage or other device with a principal purpose of creating tranches for partners to guarantee that result in exposure tantamount to a bottom-dollar guarantee. Accordingly, the proposed regulations revise the anti-abuse rule under § 1.752-2(j) to address the use of intermediaries, tiered partnerships, or similar arrangements to avoid the bottom-dollar guarantee rules. As was previously noted, the satisfaction presumption assumes that all partners and related persons will actually satisfy their payment obligations, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. The satisfaction presumption does not apply, however, to the payment obligations of disregarded entities. Instead, the payment obligation of a disregarded entity for which a partner is treated as bearing the economic risk of loss is taken into account only to the extent of the net value of the disregarded entity, as determined under § 1.752-2(k). After further consideration, the IRS and the Treasury Department believe that there are circumstances in addition to those involving disregarded entities under which the satisfaction presumption is
oriented guarantees (more technically, indemnifications under an indemnity agreement) of partnership indebtedness to shift the indebtedness to the guarantor. (This discussion simplifies the facts and analysis of Canal Corporation.) The overall transaction sought to avoid the disguised sale rules under the exception for leveraged distributions. The Tax Court disregarded the indemnity as violating the liability antiabuse rules in Treasury Regulations Section 1.752-2(j). Treasury currently has a regulations project in the works reconsidering how guarantees and other obligations affect shifting liabilities under Section 752.

A corporate subsidiary in Canal Corporation used an indemnity agreement (indemnifying against liability but not for interest) purportedly to shift the economic risk of loss of partnership indebtedness to the corporate subsidiary. The corporate subsidiary transferred to a newly organized partnership approximately $775 million in operating assets in exchange for a small partnership interest and a distribution of approximately $755 million in cash from newly borrowed funds. The other partner transferred property worth $376.4 million to the partnership in exchange for a 95% partnership interest. The corporate subsidiary used an exception under the disguised sale rules to assert that the transfer and distribution were nontaxable as merely a transfer to the corporate subsidiary of debt allocated to the
corporate subsidiary under Section 752. The corporate subsidiary did not have sufficient assets to cover its liability under the indemnification agreement if the partnership failed to pay any of the $775 million partnership loan.\footnote{A major asset of the corporate subsidiary was a promissory note from the parent corporation. The court asserted that the subsidiary could cancel this promissory note. The court also noted that the arrangement did not include a minimum net worth covenant. The party receiving the indemnification did not require the indemnification as part of the transaction. The purpose of the indemnification was merely a tax planning purpose. The indemnification did not cover interest on the loan. The corporate subsidiary also would increase its interest in the partnership if the corporate subsidiary made payments on the indemnification. The court also was critical of the accounting firm opinion that the taxpayer received in the transaction.}

The court made these observations concerning the indemnity agreement:

- The indemnification only covered the principal of the debt.
- The indemnity required the other partner to proceed against the assets of the partnership before demanding indemnification.
- The indemnification agreement provided that the taxpayer’s interest in the partnership would increase if the partner made an indemnification payment.
- The indemnification agreement did not require the taxpayer corporation to have a minimum net worth.
- The taxpayer corporation was not required to maintain a certain net worth.
- The taxpayer corporation’s net worth of $157 million represented approximately 21% of the indemnification exposure.
- The economic risk of loss of the taxpayer corporation was limited to the taxpayer corporation’s assets.
- The most valuable of which was an intercompany note that the taxpayer corporation could cancel at any time.
- The other partner knew that the taxpayer corporation’s assets were limited at the time of the transfers.
- The purpose of the agreement was to limit any potential liability of the taxpayer corporation’s assets.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The other partner did not require the indemnification.
- The indemnification did not require the taxpayer corporation to maintain a certain net worth.
- The taxpayer corporation provided the indemnification purposely to achieve tax deferral.
- The indemnification only covered the principal of the loan.
- The taxpayer corporation would receive an increased interest in the partnership if required to make indemnification payments.
- The taxpayer corporation’s agreement to indemnify the other partner lacked economic substance.
- The indemnification agreement provided the other partner no real protection. The taxpayer corporation’s primary asset was an intercompany note that could be cancelled at any time. The indemnity did not require the taxpayer corporation to retain this note or any other asset.
- The taxpayer corporation was severely undercapitalized vis-a-vis the indemnification exposure.

b. ILM 201324013.

ILM 201324013 (March 14, 2013) considered a transaction, almost literally ripped from the newspaper headlines, that generally has been identified to involve the Tribune Company’s disposition of Newsday, a Long Island, New York, newspaper, to Cablevision. A similar transaction is rumored to have involved the Chicago Cubs, a professional baseball team based in Chicago, Illinois. (This discussion simplifies the facts and analysis of ILM 201324013. ILM 201324013 involved a leveraged partnership distribution transaction designed to avoid the rules of Section 1374. ILM 201324013 concluded that the careful tax planning did not work and that the transaction was a disguised sale.

The taxpayer corporation (a qualified S corporation subsidiary of Tribune Corporation) transferred assets to a partnership. The taxpayer corporation received a large cash distribution of borrowed funds from the partnership. The taxpayer corporation used an indemnification agreement to transfer the economic risk of loss of the loan that produced the borrowed funds to the taxpayer corporation. The plan was that the transaction would qualify as a distribution of the taxpayer corporation’s share of the borrowed funds and would qualify for exemption under the disguised sale rules.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The taxpayer corporation in ILM 201324013 transferred substantial assets to a partnership with a party (Cablevision) that desired to acquire the assets. The partnership was prohibited from selling the contributed assets for 10 years.

The acquiring corporation contributed $682 million in promissory notes and cash. The promissory notes originally were intercompany debt. The credit agreement barred the partnership from disposing of the notes. The partnership also was prohibited from subordinating the notes except to the extent that any proceeds are received and those proceeds are used to refinance the notes or to invest in cash or cash equivalents. The acquiring corporation received operational control over the Newsday assets.

A wholly owned subsidiary of the partnership borrowed $612 million in cash from a third party bank lender for a five-year term. The acquiring party guaranteed the third party loan. The taxpayer corporation indemnified the guaranteeing acquiring party in order to shift the economic risk of the loan to the taxpayer corporation. The Newsday assets and the contributed promissory notes collateralized the loan. The partnership distributed the borrowed funds to the taxpayer corporation.

ILM 201324013 concluded:

- The tax law should disregard the taxpayer corporation’s indemnity under Treasury Regulations Section 1.752-2(j).
- When the indemnity is disregarded, the related contribution and distribution will be treated as a disguised sale under Section 707(a)(2)(B).
- The transaction should be recast under Treasury Regulations Section 1.701-2(b) as Y borrowing from bank to purchase a% of the contributed assets followed by the formation of a partnership.
- The tax law should disregard the form of the transaction (contribution and distribution) and treat the transaction in accordance with the underlying substance (sale).

The facts and circumstances may indicate that a principal purpose of the arrangement is to eliminate the partner’s economic risk of loss with respect to that obligation or to create the appearance of the partner bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. An obligation of a partner to make a payment then may be disregarded or treated as an obligation of another person. The tax law does not recognize an obligation of a partner to

95 Treas. Reg. § 1.752-2(j)(1).
make a payment if the facts and circumstances indicate a plan to circumvent or avoid the obligation.\textsuperscript{96}

ILM 201324013 concludes that the facts strongly indicate that the tax law should disregard the taxpayer corporation’s indemnity under Treasury Regulations Section 1.752-2(j). ILM 201324013 relied heavily on Canal Corporation. And its rejection of a similar indemnification agreement. ILM 201324013 stressed:

- The lenders imposed no net worth maintenance requirement on the taxpayer corporation.
- The lack of a net worth requirement provided the taxpayer corporation and the taxpayer corporation an exit strategy.
- Neither the lender nor the guarantors required the indemnity.
- The taxpayer corporation insisted on the obligations as a prerequisite to the transaction.
- The taxpayer corporation stands to receive the remaining collateral if required to make indemnification payments.

The taxpayer corporation may be able to either sell off assets and make distributions to shareholders or move assets to related entities in order to insulate its assets from its obligation before receiving claims under its indemnity. The absence of a net worth maintenance requirement suggests that the creditor is not concerned about the taxpayer corporation depleting its assets. The possibility of creditor causes of action for fraudulent conveyances may be too speculative to take into account in conducting a Section 752 analysis.

ILM 201324013 found that the antiabuse rule of Treasury Regulations Section 1.752-2(j) should disregard the indemnity.

ILM 201324013 found that the indemnity lacks important features typical of an indemnity in a commercially driven transaction. According to ILM 201324013, a typical indemnity expressly includes net worth maintenance requirements, an arms-length fee, an obligation to provide annual financial statements, and evidence that the parties engaged in genuine negotiations over the indemnity. Lack of these features suggests a lack of concern on the part of the lenders and guarantors over the taxpayer corporation’s ability to pay on the indemnity. Lack of these features allows the taxpayer corporation strategically to sell off assets and to make distributions to shareholders or shift assets to related entities in order to insulate its assets.

\textsuperscript{96} Treas. Reg. § 1.752-2(j)(3).
The indemnity is spurious, ILM 201324013 argued, because there is no practical or commercial risk of the indemnified party enforcing the indemnity. The partnership assets include the acquiring corporation notes. The acquiring corporation notes are collateral on the loan.

The acquiring corporation affiliates in substance are guaranteeing the acquiring corporation’s own debt, according to ILM 201324013. Neither the acquiring corporation affiliate will be able to pay on its guaranty if the acquiring corporation cannot pay on the acquiring corporation notes. The acquiring corporation and its affiliates are all part of a single economic unit. The taxpayer corporation will not have to pay on its indemnity if neither of the acquiring corporation affiliates is able to pay on its guaranty. The taxpayer corporation’s indemnity to the acquiring corporation affiliates is only for payments made on their guarantees. The taxpayer corporation has no obligation under its indemnity if the acquiring corporation affiliates default on their guarantees, even if third party bank lender has yet to be repaid. The taxpayer corporation has no obligation to third party bank lender under its indemnity.

The acquiring corporation, ILM 201324013 reasoned, merely used the partnership as a conduit to borrow from third party bank lender in order to accommodate the taxpayer corporation’s structure. The acquiring corporation notes and third party bank lender loan are similar to back-to-back loans. The principal amounts of the acquiring corporation notes and third party bank lender loan were equal. The acquiring corporation notes were issued and contributed at the same time that the partnership took out the loan. The maturity date of the acquiring corporation notes was the acquiring Year 4, while the maturity date of the loan was the acquiring Year 5.

ILM 201324013 found that the taxpayer corporation planned to avoid any realistic possibility that it would have to make any payment on its indemnity. Further, the third party bank lender debt is not even “partnership debt” to be allocated for tax basis purposes among the partners. The taxpayer corporation intended, and acted, to ensure that the partnership maintained sufficient collateral (the acquiring corporation notes or the proceeds) to repay the third party bank lender without exposing the taxpayer corporation to meaningful liability on the indemnity.

The motivation for the debt-financed distribution exception to the disguised sale rules is absent in this case, ILM 201324013 reasoned. The scenario that Congress intended to exempt from disguised sale treatment was the case in which a partner contributes property to a partnership, the partnership borrows against that property, the proceeds of the loan are distributed to the contributing partner, and the contributing partner retains liability for the repayment of the borrowed amounts. Congress intended equivalent treatment for this situation and a situation in which a partner borrows against the property outside of the partnership and contributes the encumbered property to a partnership. Congress assumed
The indemnitor’s ability to pay is not relevant in this case, ILM 201324013 argued. The taxpayer corporation structured the transaction to eliminate any commercial or practical risk that its indemnity will be called. This transaction was merely the acquiring corporation using the partnership as a conduit to borrow from the third party bank lender. The partnership must hold the acquiring corporation notes or their proceeds at least equal to its own borrowings.

ILM 201324013 asserted that the transaction documents do not require the partnership to refinance the acquiring corporation notes. Refinancing of the acquiring corporation notes was merely one of several permitted actions. Furthermore, the loan agreement restricts what the partnership may do with the acquiring corporation notes and the proceeds. The partnership would have had $e in cash from the proceeds of the acquiring corporation notes to fully repay third party bank lender in the acquiring Year 5 when the third party bank lender debt matured. If the acquiring corporation notes were not refinanced. The third party bank lender would need to approve of the terms of the refinancing if the acquiring corporation notes were refinanced. The third party bank lender would have been unlikely to approve the refinancing of the acquiring corporation notes if it believed there was a refinancing risk on its own loan. The Internal Revenue Service did not see any real “refinancing risk” in this case.

The partnership would not default unless the acquiring corporation defaults on the acquiring corporation notes. Neither of the acquiring corporation affiliates would be able to pay on its guaranty. The taxpayer corporation’s indemnity obligation would not be triggered. Furthermore, third party bank lender likely would take possession of the collateral, including the acquiring corporation notes, before bothering to seek payment from the guarantors. The acquiring corporation affiliates do have an incentive to pay on their guarantees. The taxpayer corporation would acquire the remaining the acquiring corporation notes in the event payments are required on its indemnity. Acquiring corporation affiliates would end up in the same place whether they pay on their guarantees or third party bank lender takes possession of the acquiring corporation notes directly. If the acquiring corporation defaults on the acquiring corporation notes, neither of the acquir-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ing corporation affiliates will be able to pay on its guaranty. The taxpayer corporation faces no practical or commercial risk on its indemnity. On these grounds, ILM 201324013 determines that the facts and circumstances indicate a plan by the taxpayer corporation to circumvent or avoid its indemnity, and thus, the tax law should disregard the indemnity under Treasury Regulations Section 1.752-2(j). Section 707(a)(2)(B) will treat the related contribution and distribution as a disguised sale. The indemnity is disregarded.

ILM 201324013 alternatively argues that the transaction can be recast under the general partnership anti-abuse rule in Treasury Regulations Section 1.701-2(b). ILM 201324013 observes that several aspects of the transaction are unusual. The planners designed these aspects for tax rather than business purposes. These aspects included the absence of common features of a commercial indemnity and the potential unwinding of the transaction after the end of the Section 1374 recognition period. These factors indicate that this transaction was entered into with the principal purpose of reducing a partners’ federal tax liability. The contribution of the acquiring corporation notes with a value equal to the amount of the bank debt compels a conclusion, according to ILM 201324013, that the bank debt was not “partnership debt” for purposes of Section 752. The bank debt, as a matter of substance, is the obligation of the acquiring corporation. The partnership is a mere conduit.

ILM 201324013 also cites the unusual fact that the bank loan is secured by the acquiring corporation’s equity interests in the partnership but not by the taxpayer corporation’s partnership interest. This buttresses the argument that the bank debt is, in substance, the acquiring corporation’s debt. In addition, the taxpayer corporation’s indemnity is specious. Further, the taxpayer corporation does not have a substantial business purpose in forming the partnership. The partnership form was adopted primarily as a way to avoid or defer a significant tax liability.

ILM 201324013 alternatively proposes the argument that the tax law should disregard the form of the transaction (a contribution) and treat the transaction in accordance with the underlying substance (a sale). The taxpayer corporation has effectively parted with a% of the benefits and burdens of the contributed assets while receiving cash equal to the value of a% of the contributed assets. The restriction on the partnership from transferring its assets prior to the end of the recognition period and the put and call options create the effects of a sale. The form of this transaction should be ignored and that the transaction should be treated as a sale of a% of the contributed assets under the judicial doctrine of substance over form.

Further consideration of disguised sale rules is outside the scope of this Article. That should comfort Simplicio. Many sources discussing disguised sales are readily available for Salviati in the partnership tax literature.
15. Ignore Whether Purported Partner is a Partner, the Partnership Is a True Tax Partnership, or Property Contributions Will Be Respected.

Simplicio assumes that anyone he calls a partner in the partnership agreement will be respected as a partner for tax purposes. Simplicio assumes that any partnership that he forms will be respected for tax purposes. Simplicio assumes that any contribution of property to a partnership will be respected. Salviati is more skeptical and more careful.

The partnership must be a tax partnership in order for the partnership agreement to control for tax purposes. Among other things, this requires that the partnership serve a valid business or investment purpose. A variety of situations exist in which the partner status of a purported partner or the existence of the partnership as a bona fide tax partnership have been questioned. Courts have disregarded property contributions to a partnership in other cases under the theory that the transactions lacked economic substance. This section discusses merely a small sampling of the authorities. A partnership may be recast, a partner may be recharacterized, or a contribution may be ignored under the economic substance doctrine. A purported partnership interest in some circumstances can be treated as a loan. 97

The Internal Revenue Service argued in Jade Trading LLC v. United States, 98 one of many Son-of-BOSS transactions, that a limited liability company


98 80 Fed. Cl. 11 (Fed. Cl. Ct., 2007), aff’d., 598 F.3d 1372 (Fed. Cir. 2010), on remand, 98 Fed. Cl. 453 (Fed. Cl. Ct., 2011), aff’d., 598 F.3d 1372 (Fed. Cir. 2010). See, also, Pritired 1 LLC v. United States, 816 F. Supp. 2d 693 (S.D. Iowa 2011); Hewlett-Packard Co. v. Commissioner, T.C. Memo. 2012-135. Cf. Farley Realty Corp. v. Commissioner, 279 F.2d 701 (2d Cir. 1960). Cf. William T. Plumb, Jr., “The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal,” 26 Tax L. Rev. 369 (1971). Cf. ACM Partnership v. Commissioner, T.C. Memo. 1997-115. aff’d., 157 F3d 231, (3d Cir. 1998); Commissioner v. Culbertson, 337 U.S. 733 (1949); Commissioner v. Tower, 327 U.S. 280 (1946); Fin Hay Realty Co. v. United States, 398 F2d 694 (3d Cir. 1968) (“In attempting to deal with this problem courts and commentators have isolated a number of criteria by which to judge the true nature of an investment which is in form a debt: (1) the intent of the parties; (2) the identity between creditors and shareholders; (3) the extent of participation in management by the holder of the instrument; (4) the ability of the corporation to obtain funds from outside sources;”

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(5) the “thinness” of the capital structure in relation to debt; (6) the risk involved; (7) the formal indicia of the arrangement; (8) the relative position of the obligees as to other creditors regarding the payment of interest and principal; (9) the voting power of the holder of the instrument; (10) the provision of a fixed rate of interest; (11) a contingency on the obligation to repay; (12) the source of the interest payments; (13) the presence or absence of a fixed maturity date; (14) a provision for redemption by the corporation; (15) a provision for redemption at the option of the holder; and (16) the timing of the advance with reference to the organization of the corporation. [Footnote omitted.]

ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305, aff’d., 201 F.3d 505 (D.C. Cir. 2000); Saba Partnership v. Commissioner, T.C. Memo. 1999-359, T.C. Memo. ¶ 99359, vac’d. and rem’d., 273 F3d 1135, on remand, T.C. Memo 2003-31; Boca Investerings Partnership, v. United States, 314 F.3d 625 (D.C. Cir. 2003), rev’g. 167 F. Supp. 2d 298 (D.D.C. 2001); Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006), aff’g in part, rev’g. in part and remanding, 340 F. Supp. 2d 621 (D. Md. 2004), modifying No. Civ. WDQ-02-2070, 2004 WL 2051215 (D. Md. Aug. 3, 2004); Coltec Industries, Inc. v. United States, 62 Fed. Cl. 716 (2004); Nevada Partners Fund LLC v. United States, No. 10-60559 (5th Cir. 2013); ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998); Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3d Cir. 2012); Cf. Hambuechen v. Commissioner, 43 T.C. 90 (1964) (“Numerous factors and criteria have been mentioned by this Court as well as other courts which are pertinent to the question whether a debtor-creditor relationship has been established for tax purposes. Such factors as adequacy of the capitalization of the debtor, issuance of any notes, provision for and payment of interest, presence or absence of a maturity date, intention to repay, whether the alleged debt is subordinated to claims of outside creditors, whether outside creditors would have made similar advances under the circumstances, presence or absence of security for the alleged loan, reasonableness of expectation of payment, use to which the funds were put, and whether payment can only be paid out of future profits, are a few of those most frequently mentioned. See Arlington Park Jockey Club v. Sauber, 262 F. 2d 902, 905 (C.A. 7, 1959); Nassau Lens Co. v. Commissioner, 308 F. 2d 39, 47 (C.A. 2, 1962), remanding for other reasons, 35 T.C. 268 (1960). It has been aptly stated that ‘the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event.’ Commissioner v. Meridian & Thirteenth R. Co., 132 F. 2d 182, 186 (C.A. 7, 1942), reversing 44 B.T.A. 865 (1941). Although no one factor by itself is determinative of the question, a significant factor is ‘whether the funds were advanced with reasonable expectations of

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

was merely a tax shelter vehicle for the creation of artificial tax deductions. The tax law thus should disregard the partnership. Jade Trading LLC was a test litigation vehicle for Son-of-BOSS transactions. The transaction in Jade Trading was structured and sold as a tax shelter variously by Sentinel Advisors, LLC, a hedge fund manager, Sentinel Advisors, LLC, Goldman Sachs, AIG, BDO Seidman, Curtis Mallet, and Jenkins & Gilchrist. The underlying transaction involved the purchase and sale of foreign currency options (on the European euro), creating a spread position, that was contributed to the limited liability company. The limited liability company distributed a high-basis, low value marketable asset to the taxpayer. This transaction generated a loss. The court concluded that the taxpayer would not have undertaken the spread transaction without the tax shelter plan. The Court of Federal Claims determined that the transaction did not have economic substance. The Court of Federal Claims also determined that the partnership did not have a real economic purpose. The court found that objective economic substance requires that a taxpayer prove that a transaction and a realistic financial benefit beyond tax avoidance.

The District Court ignored the partner status of partners in a tax shelter transaction in TIFD III-E Inc. v. United States (Castle Harbour).\(^9\) The Second Circuit disallowed deductions and disregarded Dutch banks as bona fide partners of a partnership. The District Court determined that the transactions did not have economic substance. The Second Circuit determined that the Dutch banks did not have a material participation in the profits of the partnership and that their interest in the transaction was really an interest as lenders. The Second Circuit determined that the parties intended that the Dutch banks’ interests would be treated as debt for nontax purposes. This was the most favorable factor to the taxpayer’s position that the Dutch banks were true tax partners. The Second Circuit found that the issuer had given an unconditional promise to pay a sum certain on demand or at a fixed maturity date in the reasonably foreseeable future. The Second Circuit found that the Dutch banks had the right to enforce payment of principal and interest because (in the court’s view) the Dutch banks could terminate the partnership. The Dutch banks then would receive the reimbursement of their investment and an agreed return. The Second Circuit found that, as a practical matter, the rights of holders of the instrument were subordinate to rights of general creditors. The repayment of the Dutch banks’ interest was even more securely protected than by priority over the general creditors. The Dutch banks did not have voting rights; this was on the side of debt rather than equity. The Second Circuit found that adequacy of capitalization and identity between holders of the disputed instrument

\(^9\) 459 F.3d 220 (2d Cir. 2006).
and stockholders of the issuer were not significant to the analysis. The Second Circuit found that the factor involving what the parties labeled the interest was equivocal. Based on these factors, the Second Circuit determined that the Dutch banks’ interest was a secured loan with equity participation. On this basis, the Second Circuit ignored the Dutch banks’ partnership interest.

Another issue that should concern the partnership agreement draftsman, particularly in the context of tax shelter partnerships, is whether a partner’s interest in the partnership is too small to be considered a true partnership interest.

Some of the concern is traced to Revenue Procedure 89-12. While now obsolete, the Revenue Procedure 89-12 was significant for partnership tax planning at one time. Advisors worry that Revenue Procedure 89-12 may still echo in the tax law. Revenue Procedure 89-12 set forth required minimum interests of the general partners, taken together, in each material item of limited partnership income, gain, loss, deduction, or credit in order to apply for a ruling. The minimum interest that Revenue Procedure 89-12 required in each limited partnership tax item was 1 percent. A profits interest generally would not be considered material unless the profits interest was substantially in excess of 1 percent and would be in effect for a substantial period of time during which it was reasonably expected that the limited partnership will generate profits. The 1 percent minimum interest was relaxed for a limited partnership where total contributions exceeded $50 million. In no event, however, other than because of a temporary allocation, could the general partners’ aggregate interest at any time in any material item be less than 0.2 percent. Revenue Procedure 89-12 also required that the general partners, taken together, must maintain a minimum capital account balance equal to either 1 percent of total positive capital account balances for the limited partnership or $500,000, whichever is less. Whenever a limited partner made a capital contribution, the general partners must have been obligated to contribute immediately capital equal to 1.01 percent of the limited partner’s capital contribution or a lesser amount (including zero) that causes the sum of the general partners’ capital account balances to equal the lesser of 1 percent of total positive capital account balances for the limited partnership or $500,000. The general partners, taken to-

---

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

together, needed not have a positive capital account balance if no limited partner capital account had a positive balance.

No clear law has developed concerning requirements for a minimum interest in partnership profits for a partner to be considered a tax partner. While this has been a matter of much speculation, there is no clear authority to date.\textsuperscript{101}

\textsuperscript{101} Cf. ECC 201326018 (June 10, 2013) (“Some states call a paid manager a “partner”. But such a person is not a partner for federal tax purposes unless they have a capital or profits interest under the Supreme Court standard in the Culbertson and Tower cases. A K-1 amount of zero may not be determinative since profits include future profits and the person may have an interest in capital appreciation. But if the listed general partner is, in fact, a partner under this standard and is the only general partner, it would be the TMP under the default rule of section 6231(a)(7)(B).”); ECC 201004031 (December 29, 2009) (“The issue of whether a person is a “partner” is purely an issue of Federal Law interpreting section 761 under the Supreme Court standard enunciated in Culbertson and Tower. If a person contributed services in a trade or business for profit, he is a partner. The fact that he may not receive a share of profits until a later year should not matter as long as his interest has vested by virtue of his contribution.”), ECC 200933033 (July 13, 2009) (“The general partner is the TMP under the largest profits interest rule because zero is the largest general partner interest. He has an interest in capital appreciation in any event which would be sufficient to constitute a profits interest of more than zero. The limitation under Treas. Reg. 301.6231(a)(7)-1(o)(2) does not apply because that limitation only applies when a partner is ‘deemed to have no profits interest’ because of death, insolvency, conversion, incompetency or liquidation.”); ECC 200945067 (September 24, 2009) (“Furthermore, you don’t need a profits interest to be a partner if you have a capital interest. If the trust actually contributed property and has a right to capital appreciation, it would meet the definition of a partner under the Supreme Court tests in Culbertson and Tower. . .”). Cf. Commissioner v. Culbertson, 337 U.S. 733 (1949); Commissioner v. Tower, 327 U.S. 280 (1946). Cf. Madison Gas & Electric Co. v. Commissioner, 72 TC 521 (1979), aff’d., 633 F.2d 512 (7th Cir. 1980); Luna v. Commissioner, 42 TC 1067 (1964) (“The following factors, none of which is conclusive, bear on the issue [of whether a tax partnership exists]. [Citations omitted.]: The agreement of the parties and their conduct in executing its terms; the contributions, if any, which each party has made to the venture; the parties' control over income and capital and the right of each to make withdrawals; whether each party was a principal and coproprietor, sharing a mutual proprietary interest in the net profits and having an obligation to share losses, or whether one party was the agent or employee of the other, receiving for his services contingent (footnote continued on the next page)
16. Ignore Section 704(c) Issues.

Simplicio does not consider the tax consequences of the contribution of low tax basis property to a partnership. These considerations are important for Salviati. Salviati should know the effects of Section 704(c) in order effectively to represent his client in negotiating the partnership agreement.

Section 704(c) will take over automatically and will affect how the partnership makes tax allocations. Section 704(c) can dramatically affect how the tax law allocates depreciation and gain or loss among partners. The choice of a method under Section 704(c) can have a dramatic effect on depreciation and gain or loss allocations.

Simplicio can compromise the partnership agreement under Section 704(c) in these ways:

- Failing to encourage his client to have his accountants prepare Section 704(c) projections.
- Failing to select a method under Section 704(c) and to provide for that method in the partnership agreement.
- Failing to address the contribution of contributed property to a subsidiary partnership and the effects of the contribution on Section 704(c).
- Failing to restrict distributions of contributed property.

compensation in the form of a percentage of income; whether business was conducted in the joint names of the parties; whether the parties filed Federal partnership returns or otherwise represented to respondent or to persons with whom they dealt that they were joint venturers; whether separate books of account were maintained for the venture; and whether the parties exercised mutual control over and assumed mutual responsibilities for the enterprise.”). Cf. In Beck Chemical Equipment Corporation, 27 T.C. 840 (1957); (“The legal relationship known as a joint venture has been defined as a ‘special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation”’); Smith v. Commissioner, 313 F. 2d 724, affirming on this issue 33 T.C. 465; Beck Chemical Equipment Corporation, supra.; Place v. Commissioner, 17 T. C. 199 (1951), aff’d. 199 F.2d 373 (6th Cir. 1952); Dreymann v. Commissioner, 11 T. C. 153 (1948),
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Failing to schedule in the partnership agreement the fair market value of each item of property contributed to the partnership. ¹⁰²
- Aggregating assets for purposes of Section 704(c) computations when asset aggregation is not permitted under the Section 704(c) regulations. ¹⁰³
- Failing to consider the effects of the sale of Section 704(c) assets by the partnership.
- Failing to consider the effects of the distribution of Section 704(c) assets by the partnership.
- Failing to consider the effect of the contribution of Section 704(c) assets by the partnership to another entity.
- Failing to consider the effects of multiple tiers of Section 704(c) adjustments.

Salviati considers the effects of Section 704(c)(1)(C). ¹⁰⁴ This provision can apply when built-in loss property is contributed to the partnership. This is all just tax mumbo jumbo to Simplicio.

¹⁰² Draftsmen typically provide an aggregate net value for contributions by each partner. Section 704(c) requires knowing the fair market value of each separate contributed asset.

¹⁰³ This is particularly an issue with securities partnerships. Considerable doubt exists with securities partnerships how to apply reverse Section 704(c) allocations on an aggregate basis. This particularly relates to using Section 704(c) allocations to effect stuffing allocations to retiring partners.

¹⁰⁴ I.R.C. § 704(c)(1)(C) (“(C) if any property so contributed has a built-in loss – (i) such built-in loss shall be taken into account only in determining the amount of items allocated to the contributing partner, and (ii) except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution. For purposes of subparagraph (C), the term ‘built-in loss’ means the excess of the adjusted basis of the property (determined without regard to subparagraph (C)(ii)) over its fair market value at the time of contribution.”). Cf. T.D. 9207, 70 Fed. Reg. 37258 (June 29, 2005) (“6. Application of Section 704(c) ¶ Under § 1.752-7(c), any § 1.752-7 liability assumed by a partnership in a § 1.752-7 liability transfer is treated under section 704(c) principles as having a built-in loss equal to the amount of the § 1.752-7 liability as of the date of the partnership’s assumption of the § 1.752-7 liability. The proposed regulations provide that, if a § 1.752-7 liability
(footnote continued on the next page)
Further discussion of Section 704(c) is outside of the scope of this Article. The partnership tax literature offers Salviati many discussions of Section 704(c).


Specially defined terms are important in most partnership agreements. Definitions receive remarkably intense scrutiny when the partnership agreement is assumed from the partnership by a partner other than the § 1.752-7 liability partner, and the trade or business or de minimis exceptions does not apply, then section 704(c)(1)(B) does not apply to the assumption and instead the rules of § 1.752-7(g) apply. Commentators asked whether section 704(c)(1)(B) applies to the assumption of a § 1.752-7 liability by another partner if the trade or business or de minimis exceptions apply to that assumption. In addition, commentators questioned whether the successor partner rule of § 1.704-3(a)(7) applies to the built-in loss amount of the § 1.752-7 liability. The successor partner rule provides that, if a contributing partner transfers a partnership interest, built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner. ¶ The intent of the Treasury Department and the IRS was that all of the rules of section 704(c), § 1.704-3, and § 1.704-4, including section 704(c)(1)(B), apply to § 1.752-7 liabilities unless otherwise specifically stated. The § 1.752-7 regulations have been modified to make this clear. In addition, § 1.704-3 has been amended to provide that § 1.752-7 liabilities are section 704(c) property and to provide that in general, the successor partner rule does not apply to § 1.752-7 liabilities. ¶ Comments were also received regarding the application of section 704(c) principles to the extent that a § 1.752-7 liability has decreased after the partnership’s assumption of the liability. Consistent with the principles of § 1.704-3, the final regulations provide that, if there is a post-assumption change in the value of the § 1.752-7 liability, resulting in an obligation amount that is either greater or less than the initial amount of the obligation, the change in the amount will be treated as a section 704(b) and not a section 704(c) item, creating book income or loss to be allocated to the partners. The final regulations also provide that, if the value of the § 1.752-7 liability decreases after the assumption of the obligation by the partnership, the ‘ceiling rule’ applies, and the partnership and the partners are entitled to adopt one of the reasonable methods specified in § 1.704-3 to correct any ceiling rule disparities.”). For comments on I.R.C. § 704(c)(1)(C), see Douglas Kahn, “Contribution of a Built-in Loss to a Partnership,” 136 Tax Notes 571 (July 30, 2012); Lukasz Rachuba, “New Issues With Partnership Built-In Loss Property,” 2005 TNT 118-42 2005 (June 20, 2005).

141
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

go to litigation. Simplicio’s common drafting mistakes include careless, imprecise, or erroneous definitions. Prior partnership agreements that are used as drafting forms often contain careless, imprecise, or erroneous definitions. These definitions can lead to interpretive difficulties and, in appropriate circumstances, can lead to economic disputes among the partners.

Some definitions in the partnership agreement can have tax or economic significance. Salviati pays careful attention to these definitions. Imprecisions or errors in the nuance in the definitions of economic terms in the partnership agreement can lead to misadventure. Salviati defines economic terms with care and precision. Some of the definitions that readily admit errors include:

- Capital Contribution.
- Adjusted Capital Contribution.
- Unrecovered Capital.
- Capital Account.
- Adjusted Capital Account.
- Minimum Gain.
- Nonrecourse Deductions.
- Partner Nonrecourse Deductions.
- Preferred return.
- Internal rate of return.
- Unpaid Return.

Salviati considers:

- Are definitions consolidated in one place?
- Are defined terms capitalized?
- Are definitions complete?
- Are definitions understandable?
- Are all defined terms used?
- Are definitions that have economic significance clear and precise?\(^{105}\)

\(^{105}\) Preferred returns are particularly difficult to draft.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Are defined terms short and sensible?
- Is substantive material included in the definitions section?\textsuperscript{106}

Simplicio can draft more efficiently, avoid dealing with any of these issues, and innocently rely on his errors and omissions insurance policy – and his protective angel.

18. Exchange Cooperation.

Partnership agreements frequently provide for exchange cooperation in connection with the retirement of a partner or a sale of partnership property by the partnership. The partnership often does not know what it has agreed to do when it promises to cooperate with an exchange of real property by one or more partners. Salviati provides a detailed cooperation provision when he provides for exchange cooperation. Distributing partnership real property to a partner is a major transaction and involves most of the legal issues that are incident to a purchase and sale transaction. Simplicio is more likely to provide a very general provision that is subject to different interpretations. In drafting an exchange cooperation provision, Salviati considers:

- Will the partnership be participating in a transaction that may create embarrassment and possibly adverse publicity for the partnership and the partners?
- Will the transaction be treated as a step transaction for tax purposes?\textsuperscript{107}

\textsuperscript{106} Most draftsman discourage putting substantive terms of the partnership agreement in the definitions section. The definitions section should be limited to definitions.

\textsuperscript{107} Cases that advisors should consider include Court Holding Company v. United States, 324 U.S. 331 (1945); Bolker v. Commissioner 760 F.2d 1039 (9th Cir. 1985); Magnesson v. Commissioner 753 F.2d 1490 (9th Cir. 1985); Mason v. Commissioner, 55 T.C.M. 1134 (1988); Chase v. Commissioner, 92 T.C. 874 (1989); Maloney v. Commissioner, 93 T.C. 89 (1989); Wagensen v. Commissioner, 74 T.C. 653 (1980); Regals Realty Co. v. Commissioner, 127 F.2d 931 (2d Cir. 1942); Margolis v. Commissioner, 337 F.2d 1001 (9th Cir. 1964); Rev. Rul. 75-292, 1975-2 C.B. 333; Rev. Rul. 77-337, 1977-2 C.B. 305; Rev. Proc. 2002-22, 2002-14 I.R.B. 733; LTR 9645005 (November 8, 1996); LTR 8642039 (July 17, 1986).
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

- Will the partnership be subjected to substantial audit expense in the event that the Internal Revenue Service audits the exchange?
- At what level will the transaction be audited by the Internal Revenue Service?
- Does the partnership agreement contain provisions that can effectively prohibit the partnership from participating in a distribution and exchange transaction?
- Does partnership indebtedness contain provisions that can effectively prohibit the partnership from participating in a distribution and exchange transaction?
- Can the distribution of a partnership property or an interest in a partnership property be *ultra vires*?
- What does the partnership promise to do when it promises to “cooperate” with a partner in a Section 1031 exchange?
- Precisely what does the partnership plan to do when it promises to “cooperate” with a partner in a Section 1031 exchange?
- How will the partnership deal with seller warranties and representations if the plan is a distribution of tenancy interest followed by a sale to a third party buyer?
- Who can cause the partnership to make the distribution?
- When is the distribution made in connection with a subsequent sale of the property?
- Is the distribution being made at the time of ultimate closing?
- Is the distribution being made prior to signing a sale agreement for the property?
- Is the distribution being made prior to signing a listing agreement for the property?
- Who will conduct sale negotiations for the sale?
- What warranties and representations does the partnership make in connection with the distribution?
- If a title problem is discovered after the distribution, is that problem an insured risk?
- How does the partnership handle existing leases?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- How does the partnership handle general liability insurance on the distribution?
- How does the partnership handle title insurance on the distribution?
- Who bears transaction expenses such as sales taxes and documentary transfer taxes?
- Will the distributing partnership be released from liability on the loan?
- Can general liability insurance be transferred from the partnership to the partner?
- Will holding real property in the name of a partner expose the partner to liability?
- Are service and operating contracts transferrable with the property?
- How does the partnership handle covenants in its loan agreements?
- How does the partnership handle bankruptcy remote limitations on the power of the partnership if the partnership is a special purpose entity?
- How does the partnership handle prorations?
- How does the partnership handle service contracts?
- How does the partnership handle equipment warranties?
- How does the partnership handle interim operations between the distribution and the sale or exchange of the property?
- How does the partnership handle notices to tenants?
- How does the partnership handle assignment of management agreements?
- How does the partnership handle assignment of franchise agreements?
- How does the partnership handle lease attornment?
- How does the partnership handle interim operations between a distribution and an exchange?
- What representations and warranties will a distributee partner be willing to give on the property.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Who engages counsel and brokers for the disposition of the property?
- How does the partnership (or how do the members) negotiate the exchange of the property?
- Who makes sellers’ warranties? Will distributee partners be willing to make customary sellers’ warranties?
- Who signs the sale agreement for the distributed property?
- Who signs the listing agreement for the distributed property?
- Will the distribution of the property be respected for tax purposes?
- Will the Court Holding doctrine apply to a distribution followed by an exchange?
- Will the exchange qualify under Section 1031?
- Who reports the gain if the exchange fails?
- Who will handle the tax audit if the exchange is questioned?
- How does the distributee partner deal with interim liabilities?
- What happens if sale of the property does not close?

19. Target Allocations in General.

Target allocations have become the rage in drafting partnership allocations of income, gain, loss, and deduction. It often seems like practically everyone uses target allocation provisions, yet it is not clear how much anyone understands them. Target allocations nevertheless are one of the more controversial subjects in partnership taxation. It is difficult to draft target allocations. There is no clear standard of how to draft target allocations. It is uncertain whether target allocations do anything at all if they are drafted properly. Furthermore, there is serious question about whether a partnership agreement providing for target allocations will meet the requirements of the rules for allocating nonrecourse deductions.

Simplicio pays little attention to the question of whether target allocations have any effect on tax allocations at all. Simplicio stumbles on the fine detail of drafting target allocation provisions. Simplicio does not understand the target allocation provisions that he uses. Perhaps no one fully understands target allocation provisions. Simplicio is not well informed of the many subtle questions involved in drafting target allocations. Careless target allocations are a valuable tool in Simplicio’s hands for compromising partnership agreements.
Target allocations are ideally suited for, and are widely used for, tax reduction. Target allocations may be used for tax avoidance in some situations. Partnerships often use target allocations in effect to deduct the retirement payments to retiring partners. The partnership’s deduction can vastly exceed the amount paid to the retiring partner. The retiring partner may have no increased income on account of the target allocation. The increased allocation to the retiring partner either offsets income the retiring partner otherwise would have on liquidation or produces a capital loss. Furthermore, partnerships can undertake abusive shifting allocation schemes for tax reduction or tax avoidance with target allocations.

Partnership agreements often allocate items of income, gain, loss, and deduction. The traditional manner of allocating these items is to lump them together in a pool of net income or net loss and then to allocate a pro rata portion of net items from the pool following specified percentages in successive tiers of allocations. For example, the partnership agreement might allocate net profits something like this if a partnership were entered between Anastasia and Ethelyn:

a. First, the partnership allocates the first $20,000 of net profits 90% to Anastasia and 10% to Ethelyn.

b. Second, the partnership allocates the next $35,000 of net profits 75% to Anastasia and 25% to Ethelyn.

c. Third, the partnership allocates the next $30,000 of net profits 50% to Anastasia and 50% to Ethelyn.

d. Finally, the partnership allocates all remaining net profits 30% to Anastasia and 70% to Ethelyn.

The partnership agreement then might provide for corresponding distributions of operating cash. The partnership agreement might provide for liquidating distributions in accordance with partner capital accounts, after the partnership has made all net income and net loss allocations. The allocation in the partnership agreement fundamentally controls partnership economics. The partnership distributes the proceeds of liquidation in accordance with partnership capital accounts.

These allocations are not target allocations.

A target allocation provision might say something like this:

The Company first will undertake the special allocations in Section aa.aa [minimum gain chargeback] and Section bb.bb [partner minimum gain chargeback]. Next, the Company will allocate all Net Income or Net Loss (and, if necessary, individual items of gross income or loss, as determined by the Manager), as the case may be, to each Member in the manner that will eliminate the difference, computed for the Member, be-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tween (or, if that is not possible, will minimize the difference between) (i) the net amount of cash that the Member would receive if the Company sold all of its assets for an amount of cash equal to its “book” value (or the amount of nonrecourse liabilities secured by an asset if greater than “book” value), paid all of its liabilities at face amount, and distributed the remaining net cash proceeds to the Members in accordance with Section xx.xx [the provision in the operating agreement governing liquidations], and (ii) the Member’s Adjusted Capital Account. For this purpose, each Member’s Adjusted Capital Account equals [i] the Member's Capital Account increased by [ii] the amount of hypothetical income that the Company would recognize and allocate to that Member on account of the sale under the Minimum Gain Chargeback and the Partner Minimum Gain. “Book” value is determined in accordance with the principles of Treasury Regulations Section 1.704-1(b)(2)(iv).109

108 This Article will use “book” value to refer to asset values corresponding to capital accounts maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv). This Article will use “book” income or “book” loss to refer to income or loss determined in accordance with the rules of Treas. Reg. § 1.704-1(b)(2)(iv).

109 This Article will not address all of the imaginative devices that have been designed to accompany target allocations. Some partnership agreements provide for Section 707(c) guaranteed payments to close the gap when target allocations do not cause capital accounts to equal the distribution scheme for hypothetical liquidation proceeds. In the case of some partnership agreements, “if an allocation of Book Income/Loss would be different if other items not yet includable in Book Income/Loss were includable in the same year as the amounts realized, the agreement might allow for the realized items to be allocated in the manner that they would have been allocated had both the realized and unrealized items been realized in the same year. As a result, when the unrealized items are realized in the subsequent year, they would be allocated so that their allocations, together with the allocation of the previously recognized items, result in Safe Harbor Capital Accounts that match the hypothetical cash-driven liquidation in that subsequent year. Making this “anticipatory” allocation would typically arise when there are unrealized gains or losses (or income or expense) that have not been taken into account as part of Book Income/Loss because there has not been an event that allows for an adjustment to the Book Value of the partnership’s assets.” See New York State Bar Association, Tax Section, “Report on Partnership Target Allocations,” Report No. 1219, 2010 TNT 185-18 (Sept. 23, 2010). Sometimes, “if a partner is entitled to a preferred return and there is concern about whether in later years the partnership will recognize sufficient items of Book Income/Loss to fill up that preference, the agreement may allow for allocations of additional amounts (footnote continued on the next page)
This is a typical target allocation provision, not a model target allocation provision. No warranty is made that this provision is the best target allocation provision (it is not) or that this target allocation provision has any effect for federal income tax purposes (it may not).

The target allocation provision typically is accompanied by cash distribution provisions (including cash distribution on liquidation) that do not expressly return to partners their capital accounts.

Simplicio uses the same target allocation provision (set forth above) in all of his partnership agreements without alteration. Salviati uses a simpler provision that says that: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.” This allocation provision should be legally sufficient. This allocation provision should be respected under Section 704.

We can debate whether the simpler one sentence provision provides inferior guidance to that provided under the typical target allocation provision. Some advisors believe that this allocation provision competes favorably with the most carefully drafted target allocation provisions – and even more favorably with target allocation provisions that are not drafted quite so carefully.

These are some of the issues involved in drafting target allocations:

- What is the general structure of a typical target allocation provision?
- Sale at book value produces fund of cash.
- Apply cash fund to repaying partnership liabilities constructively.

---

to the preferred partner in earlier years even though doing so may cause that partner’s resulting Safe Harbor Capital Account to exceed the amount distributable to the partner under a hypothetical cash-driven liquidation occurring in the year of allocation. This “anticipatory” allocation better ensures that the partner’s Safe Harbor Capital Account will equal the amount to which the partner is entitled in the later year under a hypothetical cash-driven liquidation occurring in that later year. Id. Some “target allocation provisions provide only for the allocation of net “book” Income/Loss on theory that the capital accounts do not need to equal the Deemed Liquidation Amount each year because future allocations will adjust the capital accounts such that they produce the Safe Harbor Result.” Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Determine how fund of cash would be distributed under liquidation provisions to determine Target Capital Accounts.\textsuperscript{110}

- Adjust Capital Accounts to make Adjusted Capital Accounts.\textsuperscript{111}

\textsuperscript{110} The partnership usually is treated as selling all of its assets at “book” value or for the amount of partnership liabilities secured by the asset in the case of a partnership asset subject to liabilities in excess of fair market value. Query: does a sale of an asset at “book” value make sense if the asset is subject to a binding agreement for sale of the asset at some other price? Many target allocation provision provisions refer explicitly to the partnership agreement provision governing distributions in liquidation. These provisions may not work property if a partner is a retiring partner subject to a retirement agreement that provides for a different amount to be distributed to the partner in retirement.

\textsuperscript{111} Adjustments differ from clause to clause. Typical adjustments are minimum gain and partner minimum gain. Other adjustments may be made corresponding to the adjustments under the alternate test for economic effect. See Treas. Reg. § 1.704-1(b)(2)(ii)(d) (“. . . such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and (5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and (6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made ‘(other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner’s capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain)’ under section 1.704-2 (f).”). Whether these adjustments make sense in the context of target allocations (and whether these adjustments make any sense at all) is a matter that can be debated endlessly. These adjustments are all matters that occur in a subsequent year. As the target allocation provision uses a hypothetical liquidation model, perhaps adjustments made for subsequent taxable years should be ignored. Nevertheless, it is clear that (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Allocate income, gain, deduction and loss for year until Adjusted Capital Accounts equal Target Capital Accounts.\textsuperscript{112}
- What are the adjustments to the fund of cash distributed under the target allocation provision?
- Reduce fund for liabilities that would be paid on the liquidation?\textsuperscript{113}
- Increase the fund for committed capital contributions by the partners.\textsuperscript{114}
- How do you define Adjusted Capital Accounts?

someone thought that the capital account adjustments were important for the alternate test for economic effect. These adjustments perhaps are important for target allocations. All that we can do at this point is speculate. Treasury and the Internal Revenue Service badly need to address target allocation provisions.\textsuperscript{112} Most target allocation provisions provide for adjustments made on a “book” basis.

\textsuperscript{113} The principle is to identify liabilities that normally would be paid off based on a sale of assets at “book” value an application of the proceeds first to partnership liabilities. This can produce interesting questions when a partnership liability has a serious penalty for early pay-off. A partnership liability might provide for no early pay-off and for no transfer of the security until loan maturity. The Allocation Regulations do not provide clear guidance concerning how to treat such a liability. The rules concerning contingent liabilities could be clearer. It appears that contingent liabilities should be considered real liabilities to the extent that a purchaser would discount the asset price. No clear allowance is provided for hypothetical liquidation expenses.

\textsuperscript{114} What items are treated as capital contributions by the partners? Paying a partnership obligation (or for a partner affiliate to pay a partnership obligation) might be treated as a capital contribution to the partnership. Suffering the foreclosure of partner property (or perhaps also partner affiliate property) pledged to secure a partnership obligation might be treated as a capital contribution to the partnership by a partner. These matters, however, have not been determined definitely. The alternate test for economic effect has precise requirements for timing of the obligation to satisfy capital account deficit restoration obligations. It is not clear whether these timing requirements should be imposed on the target allocation provision. It seems that, at very least, some provision should be made for contribution obligations that are not required to be satisfied within the time limits of the alternate test for economic effect.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Increase capital accounts by shares of minimum gain.
- Increase capital accounts by shares of partner minimum gain.
- Decrease capital accounts by alternate test for economic effect adjustments.

115 Treas. Reg. § 1.704-1(b)(2)(ii)(d) (“(d) Alternate test for economic effect. If – (1) Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and (2) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and (3) The partnership agreement contains a ‘qualified income offset,’ such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and (5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and (6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made ‘(other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner’s capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain’ under section 1.704-2(f). For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a ‘qualified income offset’ if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Adjust capital accounts for adjustments for contribution obligations that would be made on liquidation [possibly, perhaps likely].
- What separate allocation provisions are required or tolerated?
- Minimum gain chargeback.
- Partner minimum gain chargeback.

(4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners’ interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. . .”.

116 This matter requires an analysis of those contribution obligations and the economics of the partnership. Contribution obligations often would not be satisfied on a liquidation if the partnership is solvent at liquidation. Contribution obligations typically would be satisfied on a liquidation of the partnership if the partnership is insolvent.

117 Treas. Reg. § 1.704-2(f) (“(f) Minimum gain chargeback requirement. (1) In general. If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)). (2) Exception for certain conversions and refinancings. A partner is not subject to the minimum gain chargeback requirement to the extent the partner’s share of the net decrease in partnership minimum gain is caused by a recharacterization of nonrecourse partnership debt as partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss (within the meaning of § 1.752-2) for the liability. (3) Exception for certain capital contributions. A partner is not subject to the minimum gain chargeback requirement to the extent the partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and the partner’s share of the net decrease in partnership minimum gain results from the repayment or the increase to the property’s basis. See paragraph (m), Example (1)(iv) of this section. . .”).

118 Treas. Reg. § 1.704-2(i)(4) (“(4) Chargeback of partner nonrecourse debt minimum gain. If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner non-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Qualified income offset (maybe).\textsuperscript{119}
- Nonrecourse deductions?
- Partner nonrecourse deductions.
- Other special allocations required by the Code of by Treasury Regulations.\textsuperscript{120}
- Exculpatory deductions?\textsuperscript{121}

Parallelism between the alternate test for economic effect and partners’ interests in the partnership suggests that the qualified income offset should be required in order to comply with partners’ interests in the partnership. Nevertheless, the regulations concerning partners’ interests in the partnership do not mention a qualified income offset requirement. It is difficult to predict how a court with interpret the law in this area.


\textsuperscript{120} For exculpatory deductions and exculpatory liabilities, see 56 F.R. 66978-66995 (Dec. 27, 1991) (“A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition (footnote continued on the next page)
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

- Possibly some other special allocations where this is consistent with partnership economics.
- Should the target allocation provision allocate “book” items or tax items?  
  - Should the target allocation provision allocate net items or gross items?
  - If the target allocation provision allocates gross items, which gross items do you select to allocate to a specific partner?
  - What adjustments to Adjusted Capital Account are made under the alternate test for economic effect?  

Possibilities include:

122 “Book” items refer to “book” items as that term is used in Treas. Reg. § 1.704-1(b)(2)(iv), especially Treas. Reg. § 1.704-1(b)(2)(iv)(f), (g). A good case can be made that the target allocation provision should allocate “book” items when there is a “book”-tax difference.

123 The regulations concerning partners’ interests in the partnership are not absolutely clear that the partnership makes any of these adjustments.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Depletion adjustments reasonably expected to be made with respect to oil and gas properties.\(^{124}\)

- Allocations of loss and deductions that, as of end of the year, reasonably are expected to be made with respect to the partner under Section 704(e)(2).\(^{125}\)

- Allocations of loss and deductions that, as of end of the year, reasonably are expected to be made with respect to the partner under Section 706(d) (determination of distributive share when partner’s interest changes).\(^{126}\)

\(^{124}\) See Treas. Reg. § 1.704-1(b)(2)(ii)(d)(4) (“In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and . . . .”).

\(^{125}\) See Treas. Reg. § 1.704-1(b)(2)(ii)(d)(5) (“In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – . . . (5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and . . . .”); I.R.C. § 704 704(e)(2) (“In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor’s capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.”).

\(^{126}\) I.R.C. § 706(d) (“(d) Determination of distributive share when partner’s interest changes (1) In general Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner’s interest in the partnership, each partner’s distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year. (2) Certain cash basis items prorated over period to which attributable (A) In general If during any taxable year of the partnership there is a change in any partner’s interest in the partnership, then (except to the extent pro-\(footnote continued on the next page\)
provided in regulations) each partner’s distributive share of any allocable cash basis item shall be determined – (i) by assigning the appropriate portion of such item to each day in the period to which it is attributable, and (ii) by allocating the portion assigned to any such day among the partners in proportion to their interests in the partnership at the close of such day. (B) Allocable cash basis item For purposes of this paragraph, the term ‘allocable cash basis item’ means any of the following items with respect to which the partnership uses the cash receipts and disbursements method of accounting: (i) Interest. (ii) Taxes. (iii) Payments for services or for the use of property. (iv) Any other item of a kind specified in regulations prescribed by the Secretary as being an item with respect to which the application of this paragraph is appropriate to avoid significant misstatements of the income of the partners. (C) Items attributable to periods not within taxable year If any portion of any allocable cash basis item is attributable to – (i) any period before the beginning of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the first day of the taxable year, or (ii) any period after the close of the taxable year, such portion shall be assigned under subparagraph (A)(i) to the last day of the taxable year. (D) Treatment of deductible items attributable to prior periods If any portion of a deductible cash basis item is assigned under subparagraph (C)(i) to the first day of any taxable year – (i) such portion shall be allocated among persons who are partners in the partnership during the period to which such portion is attributable in accordance with their varying interests in the partnership during such period, and (ii) any amount allocated under clause (i) to a person who is not a partner in the partnership on such first day shall be capitalized by the partnership and treated in the manner provided for in section 755. (3) Items attributable to interest in lower-tier partnership prorated over entire taxable year If – (A) during any taxable year of the partnership there is a change in any partner’s interest in the partnership (hereinafter in this paragraph referred to as the ‘upper tier partnership’), and (B) such partnership is a partner in another partnership (hereinafter in this paragraph referred to as the ‘lower-tier partnership’), then (except to the extent provided in regulations) each partner’s distributive share of any item of the upper tier partnership attributable to the lower-tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles of subparagraphs (C) and (D) of paragraph (2)) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower-tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day. (4) Taxable year determined without regard to subsection (c)(2)(A) For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A).”)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Allocations of loss and deductions that, as of end of the
  year, reasonably are expected to be made with respect to
  the partner under Treasury Regulations Section 1.751-1
  (collapsible partnership deemed exchange rules).
- Reasonably anticipated distributions in excess of offsetting
  increases to capital account that reasonably are expected to
  occur during (or prior to) the taxable years in which the distri-
  butions reasonably are expected to be made.
- Adjustment for minimum gain or partner minimum gain.
- Certain capital contribution obligations that would be paid
  on a liquidation.
- What is target capital account of a retiring partner? Is it determined
  by the normal liquidation provision or by the amount the retiring
  partner will receive under his retirement agreement?
- What is the target capital account of a retiring partner if a retire-
  ment agreement pays the retiring partner a premium for his part-
  nership interest above the partner’s indirect interest in the fair mar-
  ket value of partnership assets?
- What is the target capital account of a retiring partner if a retire-
  ment agreement pays the retiring partner a discount for his part-
  nership interest below the partner’s indirect interest in the fair market
  value of partnership assets?
- What is the target capital account of a retiring partner who retires
  for installment payments paid over a series of years?
- What is the minimum gain adjustment to target capital account for
  a retiring partner who retires for installment payments paid over a
  series of years?
- What happens under the target allocation provision if partner re-
  tires in exchange for a stream of retirement payments in install-
  ments?
- Can special allocations be used in conjunction with target alloca-
  tions?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Do target allocations affect the result under partners’ interests in the partnership?\(^\text{127}\)
- Are target allocations subject to a substantiality test?
- Can a partnership making target allocations revalue assets on normal revaluation events? Will the presumption of the correctness of fair market value attach?\(^\text{128}\)
- Does the target allocation provision adequately allow for corrective allocations in the case of the exercise of noncompensatory options?\(^\text{129}\)

Congress, Treasury, and the Internal Revenue Service perceived that that ability to control tax allocations gave partnerships the opportunity to create abusive tax shelters. The Section 704(b) regulations were designed to counter abusive tax shelters. The Section 704(b) regulations could be considered antibuse rules.

Treasury and the Internal Revenue Service designed the Section 704(b) regulations with the thought that special allocations satisfying restrictive rules of economic effect\(^\text{130}\) and substantiality\(^\text{131}\) would not be too abusive.\(^\text{132}\)

\(^{127}\) Treas. Reg. § 1.704-1(b)(3).
\(^{128}\) Treas. Reg. § 1.704-1(h)(1) (“(h) Determinations of fair market value. (1) In general. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm’s-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.”).
\(^{129}\) Treas. Reg. § 1.704-1(b)(4)(x).
\(^{130}\) Treas. Reg. § 1.704-1(b)(2)(ii).
\(^{131}\) Treas. Reg. § 1.704-1(b)(2)(iii).
\(^{132}\) This could be questioned, for example, that have shifts outside of the five-year period considered by substantiality. This also could be questioned for “fill-up” allocations.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Treasury and the Internal Revenue Service drafted the Section 704(b) regulations under the assumption that most partnership agreements would adhere to the rules of economic effect under either the basic test of economic effect or the alternative test for economic effect. The Treasury Regulations’ rules of substantiability would control abusive schemes that the rules of economic effect did not thwart. The rules of economic effect, backed by substantially rules, have done a reasonably good example of controlling tax shelters based on abusive tax allocations.

Treasury and the Internal Revenue Service apparently gave little attention in drafting the Section 704(b) regulations to partnerships that do not adhere to the rules of economic effect by not liquidating in accordance with partner capital accounts. Partnership agreements that did not adhere to economic effect rules would be left to the nebulous test of partners’ interests in the partnership. That would not be much of a problem. Most partnerships certainly would adhere to economic effect. Few partnership agreement would rely on partners’ interests in the partnership.

As time went by, some partners, however, believed that their capital accounts at liquidation were “wrong.” These partners did not receive all of the cash to which they should have been entitled. These partners preferred that the partnership agreement describe cash distributions in a manner that these partners could understand and that did not reference partner capital accounts. These partners preferred certainty of cash distributions to certainty of tax allocations and uncertainty of tax allocations to uncertainty of cash distributions.

These partners were happier if the partnership allocated net profits and net losses using target allocations and the partnership agreement did not provide for liquidating distributions in accordance with capital account balances. Target allocations create a hypothetical sale of assets at “book” value. Target allocation provisions allocate net profits and net losses in such a way that, after these allocations, capital accounts equal the amount that would be distributed to the partners.

---

135 Treas. Reg. § 1.704-1(b)(3).
136 Treas. Reg. § 1.704-1(b)(3).
137 A partnership agreement can contain allocations that follow the general pattern of target allocations, with the partnership agreement providing for liquidating distributions in accordance with capital accounts. This Article will not include these allocation schemes as “target allocations.”
138 This Article will use “book” value to refer asset valued corresponding to capital accounts maintained in accordance with Treas. Reg. § 1.704-1(b)(2)(iv).
under the partnership agreement provision for liquidating distributions. The partnership agreement does not liquidate in accordance with capital accounts. The partnership agreement instead liquidates by straight percentages or by tiers that do not reference capital accounts.\textsuperscript{139} Target allocations subordinate the tax allocations to distribution provisions.

Many draftsmen became uncertain of their ability to master the subtleties of the economic effect\textsuperscript{140} rules. Many partners worried that the draftsmen somehow would get capital accounts wrong. The passive loss rules and the at risk rules have made loss-allocation-based tax shelter deals less attractive.

The result has been a great land rush toward partnership agreements that use target allocations and that do not liquidate explicitly in accordance with capital accounts.

The Section 704(b) regulations were not drafted with target allocations in mind. The Section 704(b) regulations do not handle target allocations particularly well. Treasury and the Internal Revenue Service, apparently overwhelmed by pressing workload, have been unable to revise the Section 704(b) regulations to deal with the many issues concerning target allocations and partners’ interests in the partnership.\textsuperscript{141} The result is an unsatisfactory state of affairs in which practitioners often guess at what the Internal Revenue Service will consider permissible.

Draftsmen who use target allocations often are impressed by the reusability and reliability of target allocation provisions. A well-drafted target allocation provision may work in practically all partnership agreements. A corporate or real estate attorney can simply pop a form target allocation provision in all of his partnership agreements and never involve a tax attorney. Target allocation provisions thus can appear to be a low-cost alternative. Low cost, reusability and perceived simplicity greatly increase the attraction of target allocations.\textsuperscript{142} The popularity of

\textsuperscript{139} A partnership agreement can contain allocations that follow the general pattern of target allocations, with the partnership agreement providing for liquidating distributions in accordance with capital accounts. This Article will not include these allocation schemes as “target allocations.”

\textsuperscript{140} See Treas. Reg. § 1.704-1(b)(2)(ii).


\textsuperscript{142} Target allocations are not economic allocations in the sense that target allocations do not control partnership economics. Target allocations are merely de-
target allocation provisions, however, would be affected adversely if the Internal Revenue Service were to determine that target allocations do not satisfy partners’ interests in the partnership.

A substantial block in the community of partnership agreement draftsmen use and defend target allocation provisions. The ranks of target allocation adherents contain some of the most knowledgeable partnership tax advisors in the country. Their views should not be disregarded lightly.\textsuperscript{143} The foundation for target allocation provisions, however, would be affected adversely if the Internal Revenue Service were to determine that target allocations do not satisfy partners’ interests in the partnership.

\textsuperscript{143} Advisors argued that allocations under target allocation provisions should be respected for tax purposes, even though target allocation provisions did not fit neatly under economic effect. Allocations under target allocation provisions make perfect sense in the views of these advisors. Allocations under target allocation provisions are consistent with the philosophical principles of partners’ interests in the partnership in these advisors’ views. Treasury and the Internal Revenue Service have not formally responded to these arguments.

Advisors argue that target allocations would be good enough most of the time, so that they should be respected for tax purposes. Even where target allocations produce controversial results, these advisors argue that these results were not too bad and could be defended.

Many different target allocation provisions say different things that may end up in different results. The target allocation provision above is not necessarily a perfect target allocation provision – not even clearly a satisfactory target allocation provision. Many different target allocation provisions say many different things and can have substantial differences when applied to a specific situation.

A consensus has evolved only on the most general contours of the target allocation provision. Target allocation provisions differ substantially within those contours. Right now, no one can tell you how to draft a perfect target allocation provision. No general agreement exists on all of the nuances of the perfect target allocation provision.

Few target allocation provisions may be drafted satisfactorily, even if target allocation provisions can affect the manner in which the partnership allocates tax items (which is uncertain). Most of the target allocation provisions in general use today may have substantial deficiencies.

\textit{(footnote continued on the next page)}
get allocations in the Section 704(b) regulations is uncertain. Saying that target allocations often describe how partners’ interests in the partnership\textsuperscript{144} will work is grounded on a much better foundation than saying that target allocations control how the partnership allocates income and loss. Draftsmen of target allocations, however, often believe that their target allocation provisions control how the partnership allocates income and loss. This matter is in debate. The Internal Revenue Service has not formally weighted in on this debate.

Widespread debate exists concerning what the target allocation provisions mean in practice. Let us assume that a partner retires with a capital account that will differ from the amount of cash that the partner will receive in retirement. The partner receives a retirement payment that is negotiated between the partnership and the retiring partner. The partnership accountants then are undertaking to compute the partnership tax return for the year of the partner’s retirement. The partnership agreement contains a fairly standard target allocation provision. Some advisors will insist that the partnership must book-up its assets to current fair market value in order for allocations to be in accordance with partners’ interests in the partnership.\textsuperscript{145} Then, to a significant extent, the allocations for the year are undertaken under Section 704(c). Other advisors will insist that the partnership is not permitted to book-up capital accounts at all. Capital account book-ups should not be permitted because the partnership does not liquidate in accordance with capital accounts. Capital account book-ups should not be permitted because they are made only for tax purposes and do not affect partnership economics. Beyond that, there is no adversity of economic interest concerning the book-ups, and the valuations will not qualify for the presumption of accuracy that generally applies to capital account book-ups. Another advisor may insist that the amount that the retiring partner receives in liquidation should be used as his target capital account, The retirement agreement in effect amends the partnership agreements’ provisions

\textsuperscript{144} Treas. Reg. § 1.704-1(b)(3).
\textsuperscript{145} Treas. Reg. § 1.704-1(b)(3).
concerning liquidation. The target allocation provision will make sense only if the target capital account of the retiring partner is equal to the amount that the retiring partner will receive in retirement. So, at least, some advisors would reason.

20. **Section 704.**

The road to the perfect target allocation provision begins with Section 704. This provision starts by advising us that: “A partner’s distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.”\(^{146}\) That is encouraging. Issues can lurk in the details.

The seemingly expansive language of Section 704(a) is qualified by the more restrictive language of Section 704(b): “A partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner’s interest in the partnership (determined by taking into account all facts and circumstances), if – (1) the partnership agreement does not provide as to the partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.”

This language takes away the seemingly unlimited freedom of the partnership agreement to allocate a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof). Section 704(b) appears to require that allocations in the partnership agreement have substantial economic effect\(^{147}\) if the tax law is to respect the allocations. Stated differently, allocations in a partnership agreement are disregarded for tax purposes if the allocations do not have substantial economic effect. Allocations are made in accordance with partners’ interests in the partnership\(^{148}\) when allocations in the partnership agreement do not have substantial economic effect.\(^{149}\)

---

\(^{146}\) I.R.C. § 704.

\(^{147}\) See Treas. Reg. § 1.704-1(b)(2)(ii).

\(^{148}\) Treas. Reg. § 1.704-1(b)(3).

\(^{149}\) This opens the door to one of the great controversies concerning target allocations. A strong case argues that target allocations do not have substantial economic effect – or, at least, that target allocations do not satisfy the basic test of partners’ interests in the partnership, the alternate test for economic effect, or the economic effect equivalence test.

(footnote continued on the next page)
This places substantial pressure on what “substantial economic effect” means. That matter by no means is clear from the language of Section 704 itself. The Treasury and the Internal Revenue Service have published many pages of guidance concerning what it means for an allocation to have “substantial economic effect.” Treasury regulations are parsimonious in detailing what “partners’ interests in the partnership” means.  


Substantial economic effect involves a two-part test. An allocation first must meet one of the tests of economic effect. The economic effect of the allocation must have substantiality under a second set of tests.

Substantial economic effect refers generally to the allocation having economic meaning: the allocation affects the manner in which cash is distributed among the partners. The allocation affects partnership economics. This is a problem with target allocations. Target allocations are merely descriptive of partnership economics.

This suggests to some advisors that target allocations will have no effect at all on how the partnership makes tax allocations.

Other advisors believe either that target allocations have substantial economic effect or, alternatively, that target allocations will affect how the partnership allocates tax items under partners’ interests in the partnership.

This controversy is perhaps the most important controversy today in partnership taxation. The stakes are sufficiently high that the controversy has taken on a political dimension that overshadows normal considerations of tax policy. Many prestigious law firms and many attorneys have put their reputations on the line by drafting partnership and LLC agreements using target allocations provisions. Substantial doubt exists that their target allocation provisions control partnership allocations of income and loss. These law firms may be routinely producing defective partnership agreements without properly counseling their clients that the legal effect of target allocations is much in doubt. These firms and draftsmen could be seriously inconvenienced if the law is resolved in favor of disregarding target allocation provisions. The debate concerning target allocations nearly assumes the dimensions of a religious debate.

For some other discussions of target allocations, see, e.g., New York State Bar Association, Tax Section, “Report on Partnership Target Allocations,” Report No. 1219, 2010 TNT 185-18 (Sept. 23, 2010); Amy S. Elliott, “IRS” Silence on...
nics. Target allocations do not control partnership economics, except in those cases in which partnerships with target allocations distribute on liquidation in accordance with capital accounts.

The allocation must be consistent with the underlying economic arrangement of the partners for an allocation to have economic effect. The partner to whom the allocation is made must receive the economic benefit in the event there is an economic benefit that corresponds to an allocation. The partner to whom the allocation is made must bear the economic burden in the event there is an economic burden that corresponds to an allocation.

Substantiality deals to a significant extent with manipulative allocations: the economic effect of the allocation must not have been manipulated so that the economic effect is merely illusory.

### 22. Tests of Economic Effect.

Three sets of rules can vest an allocation with economic effect:

- The basic test of economic effect.  \(^{155}\)
- The alternate test for economic effect.  \(^{156}\)
- The economic effect equivalence test.  \(^{157}\)

Allocations satisfying at least one of these tests also must satisfy the requirements of substantiality in order to be respected for tax purposes.

### 23. Basic Test of Economic Effect.

The basic test of economic effect \(^ {158}\) is an important stop along the road. The basic test of economic effect involves three parts. An allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides –

- Capital accounts will be maintained in accordance with the Section 704(b) regulations.
- Upon liquidation of the partnership (or any partner’s interest in the partnership), liquidating distributions are required in all cases to be


\(^{156}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d).


made in accordance with the positive capital account balances of
the partners by the end of the taxable year (or, if later, within 90
days after the date of the liquidation). These balances are deter-
dined after taking into account all capital account adjustments for
the partnership taxable year during which the liquidation occurs
(other than those made pursuant to this requirement and the next
requirement) (or, if later, within 90 days after the date of the liq-
uation).

- If the partner has a deficit balance in his capital account following
  the liquidation of his interest in the partnership, as determined after
  taking into account all capital account adjustments for the partne-
  rship taxable year during which the liquidation occurs (other than
  those made pursuant to this requirement), he is unconditionally ob-
  ligated to restore the amount of the deficit balance to the partne-
  rship by the end of the taxable year (or, if later, within 90 days after
  the date of the liquidation). This amount shall, upon liquidation of
  the partnership, be paid to creditors of the partnership or distribu-
  ted to other partners in accordance with their positive capital ac-
  count balances.\textsuperscript{159}

\begin{center}
\begin{tabular}{|c|}
\hline
\textbf{24. Alternative Test for Economic Effect.} \\
\hline
\textbf{The alternate test for economic effect}\textsuperscript{160} is another important stop on the
road to understanding target allocations. The alternate test for economic effect
makes special accommodations to the partnership that does not want unlimited
capital account deficit restoration obligations. If–

\begin{itemize}
  \item The allocation satisfies the first two requirements of the basic test of
        economic effect,
  \item The partner to whom an allocation is made is not obligated to re-
        store the deficit balance in his capital account to the partnership, or
        is obligated to restore only a limited dollar amount of such deficit
        balance, and
  \item The partnership agreement contains a “qualified income offset,”
\end{itemize}

The allocation will be considered to have economic effect to the extent the alloc-
ation does not cause or increase a deficit balance in the partner’s capital account (in

\textsuperscript{159} Treas. Reg. § 1.704-1(b)(2)(ii)(b).
\textsuperscript{160} Treas. Reg. § 1.704-1(b)(2)(ii)(d).}
excess of his limited capital account deficit restoration obligation) as of the end of the partnership taxable year to which the allocation relates. Shares of minimum gain and partner minimum gain are treated as limited capital account deficit restoration obligations.

In determining the extent to which this requirement is satisfied, the partner’s capital account is reduced for –

- Adjustments that, as of the end of the year, reasonably are expected to be made to the partner’s capital account under the capital account maintenance rules for depletion allowances with respect to oil and gas properties of the partnership, and

- Allocations of loss and deduction that, as of the end of the year, reasonably are expected to be made to the partner pursuant to Section 704(e)(2), Section 706(d), and paragraph (b)(2)(ii) of Treasury Regulations Section 751-1, and

- Distributions that, as of the end of the year, reasonably are expected to be made to the partner to the extent the reasonably expected distributions exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which the distributions reasonably are expected to be made. For this purpose, offsetting increases to capital account generally do not include increases pursuant to a minimum gain chargeback or a partner minimum gain chargeback. Increases to a partner’s capital account pursuant to a minimum gain chargeback requirement, however, are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain.161

The partnership agreement contains a qualified income offset if, and only if, the partnership agreement provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in the three capital account adjustments under the alternate test for economic effect162 (which considers reasonably expected adjustments to capital account), will be allocated items of income

---

161 Treas. Reg. § 1.704-1(b)(2)(ii)(d). There does not appear to be any special treatment of distributions of the proceeds of partner nonrecourse debt. The rules concerning capital adjustments under the alternate test for economic effect are not adequately explained in the Treasury Regulations. Not all of these adjustments may make economic sense as they are drafted.

and gain in an amount and manner sufficient to eliminate the deficit balance as quickly as possible. Material lack of certainty exists concerning most of the adjustments to capital account under the alternate test for economic effect.


A confusing stop along the road is the economic effect equivalence test. A partnership agreement may fail to satisfy either the basic test of economic effect or the alternate test for economic effect. The partnership still has a third chance of satisfying economic effect. The economic effect equivalence test provides a partnership agreement with another opportunity of satisfying economic effect. The economic effect equivalence test can apply to allocations that do not otherwise have economic effect under the basic rule of economic effect or the alternate test for economic effect. The economic effect equivalence test apparently was designed as a safety net for the less experienced draftsman who came close but did not quite satisfy the basic test of partners’ interests in the partnership or the alternate test for economic effect.

Allocations still can be deemed to have economic effect if, as of the end of each partnership taxable year, a liquidation of the partnership at the end of the year or at the end of any future year would produce the same economic results to the partners as would occur if the three requirements of basic economic effect were satisfied. The economic effect equivalence test will approve purely descriptive allocations that do not at all affect partnership economics. This represents an important departure from the basic test of partners’ interests in the partnership and the alternate test for economic effect which vest with economic

---

165 Treas. Reg. § 1.704-1(b)(3).
167 Treas. Reg. § 1.704-1(b)(2)(ii)(i) (“(i) Economic effect equivalence. Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership. See examples (4)(ii) and (iii) of paragraph (b)(5) of this section.”).
168 Treas. Reg. § 1.704-1(b)(3).
effect only those prescriptive allocations that affect partnership economics (generally enforced through liquidation in accordance with capital accounts) rather than descriptive allocations. Treasury and the Internal Revenue Service may someday wish that they never had created an exception that vests with economic effect allocations that intrinsically have no economic effect at all.\textsuperscript{170}

Some advisors believe that the economic effect equivalence test\textsuperscript{171} is a limited exception to normal rules of economic effect designed only to help the amateur partnership agreement draftsman. The economic effect equivalence test may be more important than both the basic test of partners’ interests in the partnership\textsuperscript{172} and the alternate test for economic effect\textsuperscript{173} if the economic effect equivalence test approves target allocations. Many partnerships use target allocation provisions that rely on partners’ interests in the partnership. The small exception to basic principles of economic effect may swallow the rules of economic effect – the principle that allocations with economic effect should have some economic on partnership economics. Deemed economic effect under the economic effect equivalence test seems to validate allocations that describe partnership economics rather than control partnership economics. The Internal Revenue Service has failed to provide clarification of the economic effect equivalence test beyond what is set forth in the Section 704(b) regulations.

The economic effect equivalence test\textsuperscript{174} requires that allocations that otherwise do not have economic effect and satisfy the basic test of economic effect or the alternate test for economic effect\textsuperscript{175} will have deemed economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of the year or at the end of any future year would produce the same economic results to the partners as would occur if the three requirements of the basic test of economic effect, regardless of the economic performance of the partnership.\textsuperscript{176}

An example in the Section 704(b) regulations shows that a partnership without explicit capital account deficit restoration obligations in its partnership

\textsuperscript{169} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{170} Treasury and the Internal Revenue Service could have eliminated the economic effect equivalence test and deal with these situations under partners’ interests in the partnership.
\textsuperscript{171} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{172} Treas. Reg. § 1.704-1(b)(3).
\textsuperscript{173} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{174} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{175} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{176} Treas. Reg. § 1.704-1(b)(2)(i).
agreement can satisfy the economic effect equivalence test where the partners are ultimately liable (under a State law right of contribution) for their shares of any debts of the partnership in accordance with the partnership’s basic economic ratio. This right of contribution ensures that the partnership will produce economic results consistent with the basic rules of economic effect.\textsuperscript{177}

Another example in the Section 704(b) regulations shows that a partnership with explicit capital account deficit restoration obligations in its partnership agreement can satisfy the economic effect equivalence test,\textsuperscript{178} even though the partnership agreement does not explicitly liquidate in accordance with partner positive capital accounts.\textsuperscript{179}

The analysis of the two examples in the Section 704(b) regulations is not unambiguously clear. The most common interpretation of these examples is that the economic effect equivalence test\textsuperscript{180} requires some sort of capital account deficit restoration obligation, either explicitly stated in the partnership agreement or some other agreement or implied by state law.

Some advisors propose modification or interpretation of the economic effect equivalence test\textsuperscript{181} to validate target allocation provisions. Some advisors believe that target allocations will satisfy the economic effect equivalence test without modification of the economic effect equivalence test. Other advisors disagree. The Internal Revenue Service to date has not formally expressed a view beyond what is stated in the Section 704(b) regulations.


The basic test of economic effect, the alternate test for economic effect,\textsuperscript{182} and the economic effect equivalence test\textsuperscript{183} can provide us with a forest of technical rules. The conventional wisdom seems to be that–

- A partnership agreement without either a qualified income offset or a qualifying capital account deficit restoration obligation cannot satisfy economic effect (at least for allocations that create or increase deficit capital account balances).

\textsuperscript{177} Treas. Reg. § 1.704-1(b)(5), Example 4(ii).
\textsuperscript{178} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{179} Treas. Reg. § 1.704-1(b)(5), Example 4(iii).
\textsuperscript{180} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{181} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{182} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{183} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- The partnership agreement must account for capital accounts in accordance with the capital account maintenance rules of the Section 704(b) regulations in order to satisfy the basic test of economic effect or the alternate test for economic effect.\textsuperscript{184}
- The partnership agreement must explicitly liquidate in accordance with partner positive capital accounts in order to satisfy either the basic test of economic effect or the alternate test for economic effect.\textsuperscript{185}
- The partnership agreement must produce the same result as if it liquidated in accordance with partner positive capital accounts in order to satisfy the economic effect equivalence test.\textsuperscript{186}
- The partnership agreement may require the equivalent of a capital account deficit restoration obligation in order to satisfy the economic effect equivalence test.\textsuperscript{187}

Many advisors dissent, as is usually true with conventional wisdom. These advisors may believe that an operating agreement for a limited liability company without any form of capital account deficit restoration obligation and that does not explicitly liquidate in accordance with positive capital accounts still can satisfy the economic effect equivalence test if the partnership agreement produces the same results as if the partnership liquidates in accordance with capital accounts.

27. Value-equals-basis Presumption.

The tax law applies the value-equals-basis presumption of Treasury Regulations Section 1.704-1(b)(2)(iii)(c) in determining the substantiality of economic effect.\textsuperscript{189} Although the value-equals-basis presumption is more nuanced, this pres-

\footnotesize{\textsuperscript{184} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{185} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{186} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{187} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{188} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{189} Treas. Reg. § 1.704-1(b)(2)(iii)(c) (“For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjust-}}
SOMETHING PROMISES ON HOW TO COMpromise DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Assumption generally presumes that the value of property is equal to its “book” value. One effect of the value-equals-basis presumption is that depreciation allocations are presumed not to be deprived of substantiality by corresponding gain chargebacks.\textsuperscript{190} We, however, know that the value-equals-basis presumption can be overcome in at least certain situations.\textsuperscript{191}

The Internal Revenue Service Partnership Audit Guide explains:

“The value equals basis concept presumes that the property’s basis is the maximum amount of value that the partnership can ever obtain to pay a creditor. Thus, although offsetting income allocations could come from the disposition of the property that gave rise to the original loss allocations, the regulations ignore this possibility and assume, however unrealistically, that the value of the property will never exceed its basis.

“Therefore, depreciation deductions are presumed to reflect true economic loss, regardless of what is happening in the real world. This presumption protects allocations of loss caused by depreciation and later offset by an allocation of gain on the sale of property from being attacked as transitory allocations.”\textsuperscript{192}

28. **Substantiality of Economic Effect.**

We should pay at least passing attention to substantiality as we continue along the road. Substantiality is confusing and is hidden deep within the Enchanted Forest. Allocations in a partnership agreement are not necessarily respected when these allocations have economic effect under the basic test of economic effect of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. . . .

\textsuperscript{190} The alternate test for economic effect is useful principally for limited partnership agreements where the partners wish to avoid capital account deficit restoration obligations. Importantly, the alternate test for economic effect requires that the partnership distribute the proceeds of liquidation of the partnership’s assets in accordance with positive capital accounts.


Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

subject, the alternate test for economic effect,\textsuperscript{193} or the economic effect equivalence test.\textsuperscript{194} The economic effect must be substantial in order for the tax law to respect the allocation.

The Section 704(b) regulations concerning substantiality are unfortunately complex and confusing. The rules concerning substantiality are much more complex and textured for this Article to discuss in detail. Do not trouble yourself too much if you do not understand substantiality. Few tax advisors have a deep, textured understanding of substantiality. Substantiality does not play much of a part in many attorneys’ practices.

The general principle of substantiality is that “the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”\textsuperscript{195} Substantiality is directed at allocations that are designed to manipulate the rules of economic effect for abusive purposes. Substantiality addresses allocations that have only the illusion of economic effect.

This test of substantiality applies to allocations that pass the basic test of economic effect, the alternate test for economic effect,\textsuperscript{196} or the economic effect equivalence test.\textsuperscript{197} The partnership agreement will rely on partners’ interests in the partnership to determine how the partnership allocates tax items if an allocation fails substantiality.

The economic effect of an allocation (or allocations) is not substantial if, at the time the allocation becomes part of the partnership agreement,

- The after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement, and
- 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 (or allocations) were not contained in the partnership agreement.\textsuperscript{198}

\textsuperscript{193} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{194} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{195} Treas. Reg. § 1.704-1(b)(2)(ii)(a).
\textsuperscript{196} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{197} Treas. Reg. § 1.704-1(b)(2)(ii)(i).
\textsuperscript{198} Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership are taken into account in determining the after-tax economic benefit or detriment to a partner.

The value-equals-basis presumption plays an important role in determining the substantiality of economic effect. The value-equals-basis presumption applies to all of the tests under substantiality.

The Section 704(b) regulations provide two special tests under which, if satisfied, allocations will not have substantial economic effect. One presumption considers shifting tax consequences within the same year. The other considers transitory allocations that are offset by other allocations in a later year. Both tests apply the value-equals-basis presumption.

A five-year rule provides that an original allocation and an offsetting allocation will not be in substantial “if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis).”

a. Substantiality and Shifting Tax Consequences.

The shifting tax consequences test explores allocations where allocations are offset during the same calendar year. The shifting tax consequences test disallows allocations where there is a strong likelihood that (1) the net increases and decreases in capital accounts for the taxable year will not differ substantially from the net increases and decreases that would be recorded in the partners’ respective capital accounts for the year if the allocations were not contained in the partnership agreement, and (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement with partner tax attributes that are unrelated to the partnership.

This analysis takes into account partner tax consequences that result from the allocation of the allocation with partner tax attributes unrelated to the partnership. The shifting tax consequences test takes into account the value-equals-basis presumption.

b. Substantiality and Transitory Allocations.

The transitory allocation test examines allocations where there are offsetting allocations in different taxable years. With transitory allocations, there is a strong likelihood that (1) the net increases and decreases in partners’ respective capital accounts for the taxable years to which the allocations relate will not differ substantially from the net increases and decreases that would be recorded if the

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

original allocations and offsetting allocations were not contained in the partnership agreement, and (2) the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement. This analysis takes into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership. The transitory allocation test takes into account the value-equals-basis presumption.

29. Desire Not to Liquidate by Capital Accounts.

Many partners do not want their partnerships to liquidate explicitly in accordance with positive capital accounts. These partners may not want to incur capital account deficit restoration obligations. Many of these partners opt for target allocation provisions in their partnership agreements. These target allocation provisions allocate income or loss so that, upon liquidation, partnership capital accounts will be consistent with the manner in which the partnerships will distribute the proceeds of liquidation. Each year, these partnerships will determine the “book” value of partnership assets. These partnerships will allocate gain or loss to adjust adjusted capital account balances (unusually capital account balances increased by partners’ shares of minimum gain and partnership minimum gain) so that they are consistent with the manner in which the partnerships will distribute the proceeds of liquidation.

30. Partners’ Interests in the Partnership

Allocations may fail the basic test of economic effect, the alternative test for economic effect and the economic effect equivalence test. The conventional wisdom is that partnership agreements with target allocations will use partners’ interests in the partnership to bless their target allocations. Another way in which the partnership can satisfy partners’ interests in the partnership is with an allocation provision like this: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.” Section 704 provides that a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) will be determined in accordance with the partner’s interest in the partnership (determined by taking into account all

205 Treas. Reg. § 1.704-1(b)(3).
facts and circumstances), if either the partnership agreement does not allocate distributive shares or the allocation in the partnership agreement does not have substantial economic effect.

The Section 704(b) regulations concerning partners’ interests in the partnership are not nearly so well developed as we might prefer. Simplicio does not care. Salviati is concerned.

The advantage of relying on partners’ interests in the partnership is that the partnership agreement does not have to liquidate in accordance with capital accounts or to require capital account deficit restoration. Target allocations are designed to satisfy partners’ interests in the partnership. Appreciable doubt exists that the partnership agreement can control allocations that rely on partners’ interests in the partnership. Section 704 appears to respect allocations in the partnership agreement only when those allocations have substantial economic effect.

### 31. Special Limited Rule for Determining Partners’ Interests in the Partnership.

The special limited rule for determining partners’ interests in the partnership is an important stop on the road. While comparatively few partnership agreements using target allocations will qualify under the special limited rule for determining partners’ interests in the partnership, this special limited rule may provide insight concerning the more general test of partners’ interests in the partnership. The insights from the special limited rule are often ambiguous.

If–

- The capital account maintenance and liquidation by capital account requirements of the basic test of economic effect are satisfied, and
- All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect,

The partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect is determined by comparing the manner in which distributions (and contributions) would be made if all partnership property

---

206 Treas. Reg. § 1.704-1(b)(3).
207 Treas. Reg. § 1.704-1(b)(3).
208 Treas. Reg. § 1.704-1(b)(3).
210 Treas. Reg. § 1.704-1(b)(3).
were sold at “book” value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if –

- All partnership property were sold at “book” value, and
- The partnership were liquidated immediately following the end of the prior taxable year,
- Adjusting the result for the three capital account adjustments under the alternate test for economic effect.\(^{211}\)

A determination made under the special limited rule for determining partners’ interests in the partnership\(^ {212}\) has no force if the economic effect of valid allocations made in the same manner is insubstantial under the substantiality rules.\(^ {213}\)

That is a lot to digest. The special limited rule for determining partners’ interests in the partnership\(^ {214}\) forms an important part of theoretical foundation of target allocations. We should observe the similarity of the sale at “book” value and liquidate scenario under the special limited rule for determining partners’ interests in the partnership\(^ {215}\) and the sale at “book” value and liquidate scenario under the typical target allocation provision.

The special limited rule for determining partners’ interests in the partnership\(^ {216}\) starts with a sale of all partnership property at “book” value. This sale at “book” value is important for purposes of drafting target allocations. The hypothetical sale is based on a “book” value sale rather than a sale at fair market value. The conventional wisdom seems to be that the basic test of partners’ interests in the partnership\(^ {217}\) (and the target allocation) likely requires a similar sale of all partnership property at “book” value.

Typical target allocation provisions start with a sale of all partnership property at “book” value. This represents an important step toward being able to draft a target allocation provision.

\(^ {211}\) Treas. Reg. § 1.704-1(b)(3)(iii).
\(^ {212}\) Treas. Reg. § 1.704-1(b)(3).
\(^ {213}\) Id.
\(^ {214}\) Treas. Reg. § 1.704-1(b)(3)(iii).
\(^ {216}\) Treas. Reg. § 1.704-1(b)(3)(iii).
\(^ {217}\) Treas. Reg. § 1.704-1(b)(3).
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Some partnership property may be subject to liabilities in excess of “book” value. Section 7701(g) should apply. The sale price of this property is treated as the greater of the “book” value of the property or the amount of non recourse liabilities secured by the property. The amount realized would be the greater of the “book” value of the property or the amount of non recourse liabilities secured by the property if there were an actual sale of the property. This observation also should have a place in drafting the target allocation provision.

The hypothetical sale of partnership property would produce a hypothetical fund of cash produced by the hypothetical sale of partnership assets at “book” value. The special limited rule for determining partners’ interests in the partnership then reduces that pool by the downward adjustments to capital account made under the alternate test for economic effect. These adjustments are not well understood adjustments on account of depletion, future losses allocated under Section 704(e)(2), Section 706(d), and paragraph (b)(2)(ii) of Treasury Regulations Section 751-1, and certain reasonably expected future distributions in excess of corresponding income. These adjustments under the alternate test for economic effect are complex, confusing, and uncertain. Substantial doubt exists whether some of these adjustments work at all. The fund of cash produced by the hypothetical sale at “book” value is reduced by the total downward capital account adjustments under the three capital account adjustments under the alternate test for economic effect.

Partnership liabilities reduce the fund of cash produced by the hypothetical sale of partnership assets at “book” value.

The partnership would hold a positive fund of cash after the hypothetical sale and the capital account reduction if the partnership is solvent (on a “book” basis).

The partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect is determined by comparing the manner in which distributions (and contributions) would be made after this hypothetical sale and liquidation. This comparison could be made by comparing “book” capital accounts before the hypothetical sale and liquidation (and before allocation of net

---

222 Treas. Reg. § 1.704-1(b)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

profits and net losses for the year) with the amount of cash available to distribute in liquidation.223

Income from the year is allocated to the partners in such a manner that their capital accounts will equal the amount of cash each partner will receive under the partnership agreement provisions for distributing cash in liquidation if the fund of cash produced by the hypothetical sale of partnership assets at “book” value is greater than partner capital accounts. The partnership allocates losses from the year to the partners so that their capital accounts will equal the amount of cash each partner will receive under the partnership agreement provisions for distributing cash in liquidation if the fund of cash produced by the hypothetical sale of partnership assets at “book” value is less than partner capital accounts.

The special limited rule for determining partners’ interests in the partnership224 does not explicitly refer to a capital account analysis. We are speculating when we impose a capital account analysis.

The special limited rule for determining partners’ interests in the partnership225 compares “the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made . . . .” We merely are abstracting this rule when we use a capital account analysis.

The net “book” income for the year should equal the excess of the fund of cash produced by the hypothetical sale and liquidation and total partner capital accounts before the hypothetical sale and liquidation. The special limited rule for determining partners’ interests in the partnership226 requires that the partnership allocate net “book” income to each partner in an amount necessary to cause his “book” capital account to equal the amount of cash that he would receive on liquidation after the hypothetical sale at “book” value.

We might end up with a situation in which the hypothetical sale and liquidation, which includes paying off the partnership’s debts, may result in a net deficit — i.e., the partnership is insolvent on a “book” basis and liabilities exceed “book” value. The sale will eliminate this deficit if the deficit is attributable to either minimum gain or partner minimum gain.

223 This comparison would assume that minimum gain and partner minimum gain have been recognized and allocated to partner capital accounts.
The partnership, however, might have recourse debts where one or more partners bear the economic risk of loss of the debts. The analysis should consider how the partners would bear the economic burden of these recourse debts. This analysis should determine how the partnership allocates losses under the special limited rule for determining partners’ interests in the partnership. This analysis will consider partner contribution obligations.

Several particularly interesting contrasts exist between the special limited rule for determining partners’ interests in the partnership and the alternate test for economic effect.

The alternate test for economic effect requires a qualified income offset. The special limited rule for determining partners’ interests in the partnership does not directly mention a qualified income offset requirement at all. A court might imply a qualified income offset requirement under the special limited rule for determining partners’ interests in the partnership.

A second possible difference between the special limited rule for determining partners’ interests in the partnership and the alternate test for economic effect is that the alternate test for economic effect considers only qualifying capital account deficit restoration obligations.

The alternate test for economic effect considers only capital account deficit restoration obligations that meet specified timing requirements for satisfaction of the capital account deficit restoration obligations. These contribution obligations must be required to be satisfied by the end of the taxable year of liquidation (or, if later, within 90 days after the date of the liquidation).

The special limited rule for determining partners’ interests in the partnership does not refer to any special timing requirement for contributions. Any reasonable contribution obligation might satisfy the special limited rule for determining partners’ interests in the partnership.

---

232 This subject is discussed further below.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The failure of the special limited rule for determining partners’ interests in the partnership to refer to the timing requirements for capital account deficit restoration obligations under the alternate test for economic effect may be inadvertent. Perhaps more likely, the special limited rule for determining partners’ interests in the partnership is more expansive in contribution obligations that it considers. The alternate test for economic effect in effect provides a safe harbor for special allocations. Safe harbors tend to be restrictive. Tax analysis should take into account other contribution obligations (although not illusory contribution obligations) that do not meet the restrictive timing requirements of the alternate test for economic effect in order to give proper economic weight to these contribution obligations. The special limited rule for determining partners’ interests in the partnership may not consider and give effect to these other contribution obligations.

The special limited rule for determining partners’ interests in the partnership does not say anything about the minimum gain chargeback and the partner minimum gain chargeback. The minimum gain chargeback and the partner minimum gain chargeback are governed by Treasury Regulations Section 1.704-2. Both the minimum gain chargeback and the partner minimum gain chargeback should apply automatically without the need to be set forth in the partnership agreement.244 Income that the partnership allocates under the minimum gain

---

244 See Treas. Reg. § 1.704-2(f)(1) (“(f) Minimum gain chargeback requirement. (1) In general. If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).”); Treas. Reg. § 1.704-2(i)(4) (“(4) Chargeback of partner nonrecourse debt minimum gain. If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under paragraph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner’s share of the net decrease in the partner nonrecourse debt minimum gain. A partner’s share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provi- (footnote continued on the next page)
chargeback or the partner minimum gain chargeback should be excluded from income allocated under the special limited rule for determining partners’ interests in the partnership.245

The special limited rule for determining partners’ interests in the partnership246 incorporates substantiality considerations to counter manipulative situations. How this works is a matter of speculation. The Section 704(b) regulations state that “A determination made under [the special limited rule for determining partners’ interests in the partnership] will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of [Treasury Regulations Section 1.704-1].” The trouble is that the baseline against which substantiality is measured is the allocation determined by partners’ interests in the partnership under Treasury Regulations 1.704-1(b)(3). This makes the determination of substantiality circular.247 The Section 704(b) regulations would have benefitted from providing more guidance concerning how the Allocation Regulations248 apply substantiality to the special limited rule for determining partners’ interests in the partnership.

---

247 See Treas. Reg. § 1.704-1(b)(2)(ii)(a) (“References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners’ interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).”).
248 This Article uses the term “Allocation Regulations” to refer to Treas. Reg. § 1.704-1 and Treas. Reg. § 1.704-2 together.
The special limited rule for determining partners’ interests in the partnership\textsuperscript{249} does not tell us precisely how the partnership allocates specific items of income and loss. The special limited rule for determining partners’ interests in the partnership tells us, at best, the aggregate net allocation to the partner. The partnership might presume that this net is comprised of a proportional cross-section of partnership income and loss items with certain exceptions. These exceptions would include amounts allocated under the minimum gain chargeback and the partner minimum gain chargeback. Another exception should be made for partner nonrecourse deductions, which the partnership allocates to the partner who bears the economic risk of loss.

A possible exception might be made for nonrecourse deductions. The special limited rule for determining partners’ interests in the partnership does not clearly allocate nonrecourse deductions, particularly when there are substantial shifts in the allocations under the special limited rule for determining partners’ interests in the partnership from year to year.\textsuperscript{250}

Allocations of nonrecourse deductions generally will not qualify under the safe harbor under the nonrecourse deduction regulations if the partnership uses target allocations and does not liquidate in accordance with partners’ capital accounts.\textsuperscript{251} The nonrecourse deduction regulations provide this guidance: “Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (‘nonrecourse deductions’) cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners’ interests in the partnership. If that test is not satisfied, the partners’ distributive shares of nonrecourse deductions are determined under section 1.704-1(b)(3), according to the partners’ overall economic interests in the partnership. . . .”\textsuperscript{252}

This may suggest that the partnership should not allocate nonrecourse deductions under a target allocation provision even though the partnership makes

\textsuperscript{249} Treas. Reg. § 1.704-1(b)(3)(iii).
\textsuperscript{250} There is nothing in the special limited rule for determining partners’ interests in the partnership that states that nonrecourse deductions should not be allocated under the special limited rule for determining partners’ interests in the partnership. Nonrecourse deductions are generally allocated under Treas. Reg. § 1.704-2.
\textsuperscript{251} See Treas. Reg. § 1.704-2(e).
\textsuperscript{252} Treas. Reg. § 1.704-2(a)(1).
other allocations under a target allocation provision and the target allocation provision satisfies partners’ interests in the partnership. This may suggest that nonrecourse deductions should be allocated under the target allocation provision. Allocating nonrecourse deductions under a target allocation provision may create shifting allocations of nonrecourse deductions from year to year in appropriate situations. Those shifting allocations of nonrecourse deductions might shift dramatically from year to year.

That matter, however, is not clear. The regulations concerning partners’ interests in the partnership are not clear. The partnership perhaps should allocate nonrecourse deductions under partners’ interests in the partnership in a stable manner from year to year that looks to longer-term interests in the partnership.

The matter will require further clarification from the Internal Revenue Service, Treasury, or the courts. The only guidance concerning how to allocate nonrecourse deductions outside of the nonrecourse deduction allocation safe harbor fails to provide clear guidance.

Situations may exist in which available net income or net loss available for allocation will not be large enough so that, after the allocations for the year, partner capital accounts will equal the amounts that the partner would receive after a sale at “book” value and a liquidation. These situations may require that the partnership allocate gross items of income or loss, as the case may be.\(^{253}\) Whether the special limited rule for determining partners’ interests in the partnership\(^ {254}\) will require allocations of gross income or gross loss in these situations is not clear. Which gross income or gross loss items will be allocated to the partner if the special limited rule for determining partners’ interests in the partnership can require allocations of gross income or gross losses, is not clear. The special limited rule for determining partners’ interests in the partnership does not provide clear guidance on this point.

We might view the special limited rule for determining partners’ interests in the partnership\(^ {255}\) as similar to the alternate test for economic effect\(^ {256}\) without a qualified income offset and without the tight restrictions on capital account deficit restoration obligations imposed by the alternate test for economic effect.\(^ {257}\)

\(^{253}\) Some partnership agreements will provide for guaranteed payments in this situation.

\(^{254}\) Treas. Reg. § 1.704-1(b)(3)(iii).

\(^{255}\) Treas. Reg. § 1.704-1(b)(3)(iii).

\(^{256}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d).

\(^{257}\) We also might argue that the special limited rule for determining partners’ interests in the partnership incorporates the qualified income offset by implication (footnote continued on the next page)
locations respected under the special limited rule for determining partners’ interests in the partnership, however, will not have economic effect. Even that matter is not clear. At least, loss allocations that create or increase a capital account deficit (with capital accounts specially adjusted) will not have economic effect if the partnership relies on the special limited rule for determining partners’ interests in the partnership.\textsuperscript{258} Allocations made under the special limited rule for determining partners’ interests in the partnership that do not create or increase a capital account deficit (with capital accounts specially adjusted) might have economic effect.

We can observe:

- We can abstract the special limited rule for determining partners’ interests in the partnership\textsuperscript{259} to allocate net “book” profits and net “book” losses using a capital account analysis.
- The analysis requires a sale at “book” value, followed by a liquidation.
- The partnership adjusts capital accounts by the three capital account adjustments under the alternate test for economic effect.\textsuperscript{260}
- The partnership treats minimum gain and partner minimum gain as recognized and adjusting capital accounts in the sale at “book” value.
- The partnership applies Section 7701(g) when nonrecourse liabilities exceed “book” value.
- The partnership allocates net “book” profits to adjust “book” capital account so that each partner’s “book” capital account equals the amount that the partner would receive on liquidation.\textsuperscript{261}

\textsuperscript{258} Treas. Reg. § 1.704-1(b)(3)(iii).
\textsuperscript{259} Treas. Reg. § 1.704-1(b)(3)(iii).
\textsuperscript{260} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{261} At least, we can use this approach to determine the result under the special limited rule for determining partners’ interests in the partnership. The special limited rule for determining partners’ interests in the partnership does not expressly refer to a capital account analysis.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- The partnership allocates net “book” losses to adjust “book” capital accounts to equal the amount of contributions that the partner would make on account of the liquidation. 262

- The special limited rule for determining partners’ interests in the partnership 263 does not expressly refer to a qualified income offset, but it may incorporate the qualified income offset by implication and extension of reasoning from the basic test of partners’ interests in the partnership 264 and from the alternate test for economic effect. 265

32. Basic Test of Partners’ Interests in the Partnership.

We still have not reached target allocations. We are getting closer. The road is a long road with a circuitous path. The next stop is the basic test of partners’ interests in the partnership. 266 The conventional wisdom is that target allocations usually are tested under the basic test of economic effect. 267 The rules that

262 Partners’ interests in the partnership is determined by comparing the manner in which contributions “would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section.” This does not say anything about the contribution obligations meeting the timing requirements of the alternate test for economic effect.


264 Treas. Reg. § 1.704-1(b)(3).


266 Treas. Reg. § 1.704-1(b)(3).

267 Some advisors believe that target allocation provisions can satisfy the economic effect equivalence test or perhaps even the alternate test for economic effect. The Internal Revenue Service has not formally expressed a view on whether target allocation provisions will satisfy either the alternate test for economic effect or economic effect equivalence test. For that matter, the Internal Revenue Service has not expressed a view on whether target allocation provisions satisfy partners’ interests in the partnership. This Article will assume that, if target allocations have any tax effect at all, they must satisfy partners’ interests in the partnership and that target allocations do not satisfy the alternate test for economic effect or eco-

(footnote continued on the next page)
we can establish under the basic test of economic effect are the rules that should govern most target allocation provisions.

Another way in which the partnership can satisfy the basic test of partners’ interests in the partnership is with a provision like this: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.”

The rules concerning partners’ interests in the partnership in the Section 704(b) regulations, particularly under the basic test of partners’ interests in the partnership, appear to lack the detail and craftsmanship of much of the rest of the Section 704(b) regulations. Partners’ interests in the partnership under the basic test of partners’ interests in the partnership is described as a factor analysis. The Section 704(b) regulations list but fail to inform us how to weigh these factors. The situation seems as if the draftsmen of the Section 704(b) regulations exhausted themselves on drafting the other substantive portions of the Section 704(b) regulations before they got to partners’ interests in the partnership. The portion of the Section 704(b) regulations concerning the basic test of partners’ interests in the partnership shows that exhaustion.

The basic test of partners’ interests in the partnership provides that partners’ interests in the partnership “signif[ies] 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. Except with respect to partnership items that cannot have economic effect (such as non-recourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners.”

A partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. The Section 704(b) regulations observe that “in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income

The economic effect equivalence test. Whether target allocation provisions can satisfy the alternate test for economic effect or the economic effect equivalence test must be added to the many uncertainties about target allocation provisions.

268 Treas. Reg. § 1.704-1(b)(3).
269 Treas. Reg. § 1.704-1(b)(3).
270 Treas. Reg. § 1.704-1(b)(3).
271 Treas. Reg. § 1.704-1(b)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.”

The Section 704(b) regulations apply a facts and circumstances test: “The determination of a partner’s interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners.” That principle may sound good. That principle may work satisfactorily in many situations. Many situations exist in which one does not simply look at “all facts and circumstances relating to the economic arrangement of the partners” and the correct allocation scheme for the year immediately will become apparent.

The Section 704(b) regulations setting forth the basic test of partners’ interests in the partnership look to these four factors, among others, under the basic test of partners’ interests in the partnership:

- The partners’ relative contributions to the partnership,
- The interests of the partners in economic profits and losses (if different than that in taxable income or loss),
- The interests of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation.

This factors are not exclusive. The Section 704(b) regulations do not provide a hint of other factors that might be relevant. Two factors might be the net fair market value of partnership assets and how that net fair market value would be distributed on a liquidation of the partnership. This could depart from the “book” valued based analysis of economic effect.

273 Id.
274 Id.
275 Id.
276 Treas. Reg. § 1.704-1(b)(3).
277 Treas. Reg. § 1.704-1(b)(3)(ii) (“(ii) Factors considered. In determining a partner’s interest in the partnership, the following factors are among those that will be considered: (a) The partners’ relative contributions to the partnership, (b) The interests of the partners in economic profits and losses (if different than that in taxable income or loss), (c) The interests of the partners in cash flow and other non-liquidating distributions, and (d) The rights of the partners to distributions of capital upon liquidation. . . .”).
The analysis of partners’ interests in the partnership under the Section 704(b) regulations provides us with limited tools with which to determine partners’ interests in the partnership in hard cases. This analysis also provides us with limited guidance concerning how to draft a target allocation provision.

Many advisors, very possibly a majority of advisors, believe that partners’ interests in the partnership imposes an analysis requiring a sale at “book” value and liquidation plus a capital account analysis. This is not what the Section 704(b) regulations say. The Section 704(b) regulations could have been considerably more direct if they were designed to impose a sale at “book” value followed by a liquidation distribution in accordance with capital accounts. The four factor approach expressed in the Section 704(b) regulations seems considerably more holistic than a purely mathematical test based on capital accounts. The four factors suggest the possibility that the basic test of partners’ interests in the partnership might consider factors such as actual fair market value and solvency of the partners.278 The basic test of partners’ interests in the partnership might consider other practical facts and circumstances.

Many advisors infer a sale at “book” value, a liquidation, and a capital account analysis from the general scheme of the Section 704(b) regulations. These advisors apply that analysis to the basic test of partners’ interests in the partnership.279 Partnerships will have to wait for further development of the tax law before they know whether this analysis is a correct application of the basic test of partners’ interests in the partnership.

Many advisors speculate that the tax law will approve a capital account analysis – or something approximating a capital account analysis – for partners’ interests in the partnership when these advisors draft target allocation provisions. The two most reasonable approaches are the partners’ interests in the partnership should make sense on a “book” basis or partners’ interests in the partnership should make sense on a current fair market value basis.

As confidently as any of us may appear to be about partners’ interests in the partnership, no one knows with confidence how partners’ interests in the part-

278 Treas. Reg. § 1.704-1(b)(3).
279 See Treas. Reg. § 1.752-2(b)(6) (“For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”).
280 Treas. Reg. § 1.704-1(b)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tership will be resolved in a broad range of situations. Most of what this Article says about partners’ interests in the partnership is based on mere speculation.

The explicit rules concerning the basic test of partners’ interests in the partnership use very different language from the special limited rule for determining partners’ interests in the partnership. These are some of the contrasts:

- The basic test of partners’ interests in the partnership does not say anything about capital accounts.

- The special limited rule for determining partners’ interests in the partnership at least implies an analysis that can be expressed as a capital account analysis, although this portion of the Section 704(b) regulations does not mention capital accounts.

- The basic test of partners’ interests in the partnership does not say anything about “book” values.

- The basic test of partners’ interests in the partnership does not say anything about a hypothetical sale of assets.

- The basic test of partners’ interests in the partnership does not say anything about a liquidation.

- The basic test of partners’ interests in the partnership does not say anything about capital account adjustments under the alternate test for economic effect.

---

281 Treas. Reg. § 1.704-1(b)(3).
283 Treas. Reg. § 1.704-1(b)(3).
284 The special limited rule for determining partners’ interests in the partnership does not mention capital accounts, but the rule could be re-expressed using the terminology of capital accounts.
286 Treas. Reg. § 1.704-1(b)(3).
287 Treas. Reg. § 1.704-1(b)(3).
288 Treas. Reg. § 1.704-1(b)(3).
289 Treas. Reg. § 1.704-1(b)(3).
290 One might argue that the adjustments under the alternate test for economic effect do not make any sense – or that these adjustments are too hypertechnical to be practical. See Treas. Reg. § 1.704-1(b)(2)(ii)(d)(4), (5), (6) (“. . . In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for – (4) Adjustments that, as of the end of such . . .

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The basic test of partners’ interests in the partnership\(^{291}\) does not mention the alternate test for economic effect\(^{292}\) at all.
- The basic test of partners’ interests in the partnership\(^{293}\) does not say anything about substantiality.

How much the basic test of partners’ interests in the partnership\(^{294}\) will borrow from the principles of the special limited rule for determining partners’ interests in the partnership\(^{295}\) in determining partners’ interests in the partnership

---

\(^{291}\) Treas. Reg. § 1.704-1(b)(3).
\(^{293}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\(^{294}\) Treas. Reg. § 1.704-1(b)(3).
\(^{295}\) Treas. Reg. § 1.704-1(b)(3)(iii).
under the basic rule of partners’ interests in the partnership, is not clear. Both tests seek the same objective of establishing partners’ interests in the partnership. A partnership could expect that many principles would be interchangeable between the two tests. How much the basic test of partners’ interests in the partnership borrows from the alternate test for economic effect, also is not clear. Both tests seek the same objective. Both tests perhaps should be generally parallel – or so we might suppose.

A partnership may have difficulty knowing what to make of the Allocation Regulations mentioning a consideration in one provision and not in another. The consideration might be carried over to the basic test of partners’ interests in the partnership by implication. The consideration might be excluded from the basic test of partners’ interests in the partnership under theory that Treasury and the Internal Revenue Service have shown that they can list this consideration when they feel that it is appropriate.

Partners’ interests in the partnership under the basic test of partners’ interests in the partnership is plagued with a host of unresolved issues. The resolution of these issues is important for drafting a target allocation provision that satisfies partners’ interests in the partnership. A draftsman could be well equipped to draft an excellent target allocation provision if we could unambiguously answer all of the following inquiries. In the interim, a draftsman can use an allocation provision like this: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.” Unresolved issues include:

- What analysis does the basic test of partners’ interests in the partnership use to determine partners’ interests in the partnership under?
- Does the basic test of partners’ interests in the partnership involve a capital account analysis – or, at least, may that basic test of partners’ interests in the partnership appropriately be expressed as a capital account test?

---

297 Treas. Reg. § 1.704-1(b)(3).
298 Treas. Reg. § 1.704-1(b)(3).
300 Treas. Reg. § 1.704-1(b)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Is the basic test of partners’ interests in the partnership\(^{301}\) based on a fair market value analysis or a “book” value analysis?
- When and how does partners’ interests in the partnership depart from a pure capital account analysis?
- Does the basic test of partners’ interests in the partnership\(^{302}\) make the three capital account adjustments under the alternate test for economic effect?\(^{303}\)
- What adjustments do the Allocation Regulations make to capital account in determining partners’ interests in the partnership and what obligations do the Allocation Regulations consider if a capital account analysis is used in determining partners’ interests in the partnership?
- Do the Allocation Regulations base the basic test of partners’ interests in the partnership\(^{304}\) on a hypothetical sale of assets followed by a liquidation?
- If so, is the hypothetical sale at “book” value or fair market value – or perhaps some other value?
- Does the basic test of partners’ interests in the partnership\(^{305}\) require – or allow – a qualified income offset?
- Do substantiality considerations test allocations that otherwise might satisfy partners’ interests in the partnership under the basic test of partners’ interests in the partnership?\(^{306}\)
- If so, how is substantiality applied to the basic test of partners’ interests in the partnership?\(^{307}\)
- What baseline allocation scheme do the Allocation Regulations use for applying substantiality to the basic test of partners’ interests in the partnership?\(^{308}\)

\(^{301}\) Treas. Reg. § 1.704-1(b)(3).
\(^{302}\) Treas. Reg. § 1.704-1(b)(3).
\(^{303}\) See note 290.
\(^{304}\) Treas. Reg. § 1.704-1(b)(3).
\(^{305}\) Treas. Reg. § 1.704-1(b)(3).
\(^{306}\) Treas. Reg. § 1.704-1(b)(3).
\(^{307}\) Treas. Reg. § 1.704-1(b)(3).
\(^{308}\) Treas. Reg. § 1.704-1(b)(3).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Is the value-equals-basis presumption used in determining substantiality under partners’ interests in the partnership?
- Does the five-year substantiality presumption apply to allocations under partners’ interests in the partnership?
- Does partners’ interests in the partnership require allocations of gross income and gross loss items – or is partners’ interests in the partnership limited to allocations or net income and net losses?
- Does partners’ interests in the partnership operate on “book” items or on tax items?
- What is necessary for the Allocation Regulations to respect a limited capital account deficit restoration obligation in determining partners’ interests in the partnership?
- Are capital account deficit restoration obligations or contribution obligations subject to the timing requirements provided under the basic test of partners’ interests in the partnership\(^{309}\) in order to be given effect under the basic test of partners’ interests in the partnership?
- To what extent is the value-equals-basis presumption relevant in determining partners’ interests in the partnership?
- Is the value-equals-basis presumption rebuttable or irrebuttable?
- What facts are necessary to rebut the value-equals-basis presumption, if the value-equals-basis presumption is rebuttable?
- To what extent is the presumption of unlimited partner solvency under the Section 752 regulations\(^{310}\) applied to partners’ interests in the partnership?
- Can the partners affect the results of partners’ interests in the partnership by adding guidance in the partnership agreement concerning tax allocations?

\(^{309}\) Treas. Reg. § 1.704-1(b)(3).

\(^{310}\) Treas. Reg. § 1.752-2(b)(6) (“For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- How are nonrecourse deductions allocated under partners’ interests in the partnership?
- Should nonrecourse deductions be allocated under a target allocation provision or allocated separately outside of the target allocation provision?
- Does partners’ interests in the partnership have a unique solution for a particular partnership in a particular year or is there the possibility of multiple solutions to partners’ interests in the partnership?
- How does partners’ interests in the partnership select precisely which items of income or loss the partnership allocates to each partner, if various allocation schemes produce the same capital account effects?
- Are target allocations governed by partners’ interests in the partnership?
- How do the Allocation Regulations allocate nonrecourse deductions under partners’ interests in the partnership?
- How are exculpatory deductions\(^\text{311}\) allocated under partners’ interests in the partnership?\(^\text{312}\)

\(^{311}\) On exculpatory deductions and exculpatory liabilities generally, see Karen C. Burke, “Exculpatory Liabilities and Partnership Nonrecourse Allocations,” 57 Tax Lawyer 33 (2003); Bethany Adkins Rice, “Does Regulation Section 1.704-2 Permit Special Allocations of Nonrecourse Deductions Attributable to Exculpatory Liabilities?” 56 Tax Lawyer 155 (2002); Susan Kalinka, “Qualified Nonrecourse Financing and the Allocation of Exculpatory Liabilities,” 77 Taxes 20 (1999); LTR 199906025 (Nov. 17, 1998); Great Plains Gasification Associates v. Commissioner, 92 T.C.M. (CCH) 534 (2006). Exculpatory liabilities are a class of liabilities that are “not secured by any specific property and [are] recourse to the partnership as an entity, but explicitly not recourse to any partner.” See T.D. 8385, 56 Fed. Reg. 66978-66995 (December 27, 1991). See T.D. 8385, 56 Fed. Reg. 66978-66995 (December 27, 1991) (“A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. Under that definition, an exculpatory liability is a nonrecourse liability. The application of the nonrecourse debt rules of section 1.704-2 – more specifically, the calculation of minimum gain – may be difficult in the case of an exculpatory lia-

\(^{312}\) (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Can particular income or loss items be specially allocated under partners’ interests in the partnership?
- Can partners’ interests in the partnership require that particular income or loss items be specially allocated?
- Are partnerships that use partners’ interests in the partnership permitted or required to revalue assets, to redetermine capital accounts on permitted revaluation events?
- If so, do partnerships that use partners’ interests in the partnership afterwards compute income and loss applying reserve Section 704(c) principles?
- Do target allocations have any tax effect or do anything at all for tax purposes?
- Do target allocations at least correctly explain partners’ interests in the partnership if target allocations do not have any effect for tax purposes?
- How do you draft target allocations provisions if target allocations can affect tax allocations?
- How do you draft target allocations if target allocation are valuable merely to explain partners’ interests in the partnership?
- Can a partnership using target allocations and not liquidating in accordance with capital accounts redetermine capital accounts on permitted revaluation events?

ability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached to the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b). Commentators have requested that the treatment of allocations attributable to exculpatory liabilities under the nonrecourse debt rules be clarified. The Service and the Treasury solicit further suggestions on the appropriate treatment of allocations attributable to these liabilities. Suggestions should take into account the practical concerns of partnerships as well as the Service’s concerns about the proper allocation of loss and gain items attributable to these liabilities.”). The tax law concerning exculpatory deductions is not well developed.

312 This subject is discussed further later in this Article.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should target allocations be allocations of net income and loss or gross income and loss?
- Can the partnership specially allocate items consistent with using target allocations?
- How do you determine what specific tax items should be allocated as target allocations when target allocations are allocations of gross income and gross losses?
- What adjustments, if any, to capital accounts or to the fund of cash produced by the hypothetical sale of partnership assets at “book” value distributed in the hypothetical sale and liquidation should be made for target allocations?
- Does a presumption of unlimited partner solvency apply to determining partners’ interests in the partnership?313
- What items (such as nonrecourse deductions, partner nonrecourse deductions, exculpatory deductions, minimum gain chargeback, and partner minimum gain chargeback) should be allocated separately from target allocations?
- Should target allocations be accompanied by separate minimum gain chargebacks and partner minimum gain chargebacks?
- Are target allocations compatible with having other special allocations?
- Are target allocations appropriate where the partners have different economic deals with respect to different pockets of assets?
- Can the partnership agreement reallocate tax items in prior taxable years and amend prior years’ tax returns if capital accounts for the current year do not conform to the liquidation scheme after the application of the target allocations for the current year?

This is a formidable list of questions. The answers to many of these questions are uncertain. These questions become important in drafting target allocation

313 Treas. Reg. § 1.752-2(b)(6) (“For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

provisions to the extent that target allocation provisions rely on the basic test of partners’ interests in the partnership.  

Partners’ interests in the partnership is an open field for conjecture. Advisors should be careful not to confuse conjecture – however thoughtful – with firmly established tax law. Operating under partners’ interests in the partnership is operating in a world of uncertainty. Operating under partners’ interests in the partnership is an adventure on the road through the Enchanted Forest.

33. Some Inquiries about Target Allocation Provisions and Partners’ Interests in the Partnership.

Do target allocations have any tax effect or do anything at all for tax purposes? The answer is that we do not know. Advisors are divided in their views. Advisors on both sides of the debate typically seem positive of their positions. Most partnership tax advisors have enthusiastic views on this subject.

Many advisors (including most advisors who draft target allocation provisions) apparently believe that target allocations do control tax allocations. The most common explanation is that is that these target allocations satisfy partners’ interests in the partnership. Some advisors, however, believe that their target allocations satisfy the economic effect equivalence test or should satisfy the economic effect equivalence test if that test were properly clarified. A small group of advisors perhaps believe that their target allocation provisions for limited liability companies will satisfy the basic test of economic effect or the alternate test for economic effect.

What receives less attention among the pool of advisors who believe that their target allocation provisions satisfy partners’ interests in the partnership is

---

314 Treas. Reg. § 1.704-1(b)(3).
316 The New York State Bar Association, Tax Section, “Report on Partnership Target Allocations,” Report No. 1219, 2010 TNT 185-18 (Sept. 23, 2010), suggests revising the economic effect equivalence test so that target allocations would qualify under that test. The relevance of whether target allocations satisfy the economic effect equivalence test or partners’ interests in the partnership is important principally for secondary effects of economic effect under such provisions as Section 514(c)(9)(E).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

precisely what is necessary for a target allocation provision to satisfy partners’ interests in the partnership. A target allocation provision perhaps theoretically could satisfy partners’ interests in the partnership if the target allocation provision were properly drafted. Many target allocation provisions are drafted in such a manner that they may not satisfy partners’ interests in the partnership. Many target allocation provision are drafted in such a manner that they sometimes may not satisfy partners’ interests in the partnership. Target allocation provisions also may fail to qualify as proper allocations of nonrecourse deductions. Target allocation provisions normally should not qualify for allocating partner nonrecourse deductions.

The possible generic infirmity of target allocations may be that target allocations do not affect partnership economics. Target allocations, properly drafted, are merely descriptive of partnership economics. Target allocations do not affect how the partnership distributes cash, except in the unusual situation in which the partnership uses target allocations and liquidates in accordance with capital accounts.

The tax law is not clear that a descriptive allocation controls partners’ interests in the partnership (as opposed to describing the result that partners’ interests in the partnership would reach in the absence of the target allocation). Some advisors believe that target allocations accurately describe partnership economics and therefore should be respected for tax purposes. Other advisors believe that target allocations do not control partnership economics and therefore, whether they accurately describe partnership economics or not, these target allocations should not be respected for tax purposes. The tax law has yet to resolve this issue. There also are situations in which many target allocation provisions may not accurately describe partners’ interests in the partnership.

Target allocations provisions, properly drafted, provide a reasonable interpretation of partners’ interests in the partnership in many circumstances.\textsuperscript{319} The entire scheme of economic effect is based on a capital account analysis. The special limited rule for determining partners’ interests in the partnership\textsuperscript{320} can be abstracted as a capital account analysis, based on a sale of all partnership assets at “book” value and liquidation of the partnership. The basic test of partners’ interests in the partnership\textsuperscript{321} could use a capital account analysis, by extension of reasoning. Target allocations follow a sale at “book” value and liquidation analysis. That much makes target allocation provisions attractive as descriptive of the re-

\textsuperscript{319} This is not equivalent to saying that the target allocation provisions will control rather than merely describe partnership allocations.

\textsuperscript{320} Treas. Reg. § 1.704-1(b)(3)(iii).

\textsuperscript{321} Treas. Reg. § 1.704-1(b)(3).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

...ults that partners’ interests in the partnership would reach independent of the target allocation.

That does not, however, mean that target allocation provisions work in the sense that target allocation provisions affect how the partnership allocates income and loss. Partners’ interests in the partnership under the basic test of partners’ interests in the partnership is based on an economic analysis of facts and circumstances.

The language of the basic test of partners’ interests in the partnership does not directly support the conclusion that the partnership can affect how the partnership allocates tax items under partners’ interests in the partnership by putting an allocation in the partnership agreement – whether a target allocation or otherwise.

The language of Section 704 basically says that allocations in a partnership agreement are respected if those allocations have substantial economic effect. Allocations under a target allocation provision appear generally not to have substantial economic effect – or any other economic effect. The allocations in a partnership agreement that uses target allocations often are consistent with the allocations that likely will satisfy partners’ interests in the partnership, but that does not necessarily support the conclusion that the allocations in the partnership agreement control how the partnership allocates tax items.

The target allocation provision may be merely descriptive of partners’ interests in the partnership without the target allocation provisions affecting how the partnership allocates items under the partnership agreement. A partnership with a target allocation provision in its partnership agreement might end up with profits and losses allocated in precisely the same way in which profits and losses would be allocated if the partnership agreement contained no allocations. That is a possibility, but it is merely conjecture.

A partnership might not have any allocations at all in its partnership agreement. The Internal Revenue Service or a court presumably can determine how the partnership should report its tax items in accordance with partners’ interests in the partnership. The Internal Revenue Service or a court perhaps should be able to reach a unique result under partners’ interests in the partnership. If so, two different allocation schemes cannot simultaneously satisfy partners’ interests in the partnership based on identical partnership economics. The premise that two or more allocation schemes (potentially producing different tax results for the partners) simultaneously satisfy partners’ interests in the partnership is difficult for

---

322 Treas. Reg. § 1.704-1(b)(3).
323 Treas. Reg. § 1.704-1(b)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

some advisors to accept. Partnerships do not know how the Internal Revenue Service or a court would be able to select between the two different allocation schemes in order to determine partners’ tax liabilities. Two or more allocation schemes simultaneously satisfying partners’ interests in the partnership, would create the possibility that each partner might simultaneously have two different tax liabilities – one based on each allocation scheme.

Another argument against target allocation provisions is that target allocations may produce abusive allocations in appropriate situations. Approving target allocations might result in approving a route to constructing abusive tax shelters or abusive tax transactions. Approving target allocations might approve an end run around substantiality.

All of this is entirely speculative. Many advisors believe that target allocations should be respected and that target allocations are not abusive. Many advisors believe that target allocation provisions will control partnership allocations of tax items. The business community has made a substantial investment in partnership agreements with target allocation provisions.

Target allocation provisions govern many partnerships. Businesses often seek comfort in large numbers. Large numbers often sway the resolution of the tax law. At the least, large numbers can constitute material political power. The large numbers of partnerships that use target allocations might well cause a substantial dislocation of business if the Internal Revenue Service were suddenly to announce that target allocation provisions are pure nonsense and of no tax effect at all – or merely describe rather than control of partners’ interests in the partnership. The large numbers of partnerships that use target allocations – and perhaps also the perception that these allocations generally do not produce abusive results – are a strong practical argument in favor of target allocations.

324 Not all advisors concede that target allocation provisions necessarily produce nonabusive results. For example, target allocations become “fill-up” allocations to a retiring partner when a partner retires from the partnership. This can produce large income or loss allocations to the retiring partner without affecting partnership economics. The retiring partner may be allocated large amounts of income without increasing the retiring partner’s tax liability. This can make retirement payments to the retiring partner economically deductible to the partnership. This transaction might be perceived as abusive. As more abuses of target allocation provisions are identified, the likelihood that target allocations will be approved by the Internal Revenue Service declines. Some advisors argue that the typical target allocation provision, properly interpreted, does not allocate gain disproportionately to the retiring partner. Instead, the retiring partner’s target capi-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

An issue that has received little attention is whether the tax system is better off with (i) the Internal Revenue Service setting forth rules for target allocations (ii) the Internal Revenue Service should admit that target allocations do not have tax effect and the Internal Revenue Service should spend its time designing sensible rules governing partners’ interests in the partnership. Clear rules for partners’ interests in the partnership might make target allocations unnecessary. No one has set forth a strong policy case for approving target allocations. The typical case is that many partnerships use target allocations, target allocations usually are not too bad, target allocations usually are not abusive, and target allocations often approximate the results of partners’ interests in the partnership. This is hardly a compelling case for approving target allocations.325

The diversity of target allocation provisions suggests the possibility that the Internal Revenue Service might approve some target allocation provisions and reject others. For example, the Internal Revenue Service might approve target allocations only if they are made as gross item allocations or only if certain adjustments are made to capital accounts or to the hypothetical proceeds of liquidation. The Internal Revenue Service also might approve target allocations only if the partnership regularly redetermines capital accounts on revaluation events.

The Internal Revenue Service to date has not announced a position on target allocations. We are not going to resolve the issue of what target allocations work and what target allocations do not work in the absence of Internal Revenue Service guidance.

What is the target for target allocations? Target allocations typically adjust “book” income and loss so that adjusted capital accounts (capital accounts subject to a variety of adjustments) equal target capital accounts. Some advisors have questioned what that target should be.

The simplest approach to the target capital account is that this target is the amount, for each partner, that the partner would receive if the partnership liquidated its assets in a sale at “book” value, paid off its liabilities, and distributed the

tal account is based on the amount that he would receive under the normal liquidation priorities without reference to the amount that he receives on retirement.

325 There is a broad range of target allocation provisions available in the marketplace. If target allocation provisions can work to control partnership allocations, it is not clear what the target allocation provisions should say and how they should operate to control partnership allocations. It is possible that target allocations provisions work in the abstract, but that a particular target allocation provision may not work.
proceeds in accordance with the provision in the partnership agreement for liquidating distributions. This is how most target allocation provisions are drafted.

This target may be wrong in some cases. The partnership may negotiate the buy-out of a partner who would receive $100,000 under the sale at “book” value and liquidation model. The agreement between the partner and the partnership may provide for retiring the partner’s interest for $1,500,000, to be paid during the current year. This $1,500,000 presumably reflects the retiring partner’s indirect interest in the fair market value of partnership assets. Many would argue that this $1,500,000 payment best reflects partnership economics and that the $100,000 that the partner would receive under the normal liquidation provision no longer has relevance on account of the redemption agreement. The $1,500,000 may be the appropriate target capital account for applying a target allocation provision. Further, the $1,500,000 (rather than the amount provided in the liquidating distribution under the partnership agreement) likely reflects the amount that the retiring partner would receive if the partnership did liquidate during the year of the redemption of the partner. The retirement agreement in effect amends the normal liquidation distribution provisions.

This is very different from how most target allocation provisions work. Target allocation provisions typically merely refer to the paragraph that provides for normal liquidating distributions and do not consider the possibility of the earlier redemption of a partner.

Someone might object that the amount that the retiring partner receives under the retirement agreement may reflect considerations other than merely the retiring partner’s claim to a share of the assets of the partnership. The retiring partner may receive a premium on account of the retiring partner’s control over partnership operations. The retiring partner may receive a discount on account of minority interest. The retiring partner may receive a nuisance premium on account of the partnership’s desire to rid itself of the retiring partner, or the retiring partner may receive a discount on account of the retiring partner’s desire to separate himself from the business of the partnership. The retiring partner might sign a non-competition agreement in connection with his retirement. Part of what the retiring partner receives might reflect value that in effect represents a prepayment for the future noncompetition with the partnership’s business. The retiring partner may receive an additional payment in exchange for the retiring partner’s pledge to help to transition his partnership business (such as law or accounting clients) to other partners of the partnership.

It is not altogether clear how the target capital account should take into account – or fail to take into account – all of these considerations that do not directly reflect the retiring partner’s indirect interest in the assets of the partnership. Some will argue that the target capital account should reflect only the retiring partner’s indirect share of the value of partnership assets, albeit adjusted to the extent that
some comments on how to compromise drafting partnership and llc agreements and some basic issues in drafting real estate partnership and llc agreements

this value is reflected in retirement payments to the retiring partner. others would treat the retiring partner’s target capital account as the full amount that the retiring partner receives in retirement. of course, others would look to the amount that the retiring partner receives under the partnership’s normal provision for distributions in liquidation as establishing the retiring partner’s target capital account. the courts or the internal revenue service presumably will have the opportunity someday to resolve these issues. these issues have not been satisfactorily resolved to date.

do target allocations at least correctly explain partners’ interests in the partnership if target allocations do not have any effect for tax purposes? target allocations often should accurately describe the results of partners’ interests in the partnership, or so we may imagine. this at least is a good conjecture. the general structure of economic effect adopts a capital account analysis. a constructive sale at “book” value and liquidation seems consistent with the general analysis of economic effect. we readily can imagine that partners’ interests in the partnership could be substantially parallel to economic effect.

the sale and liquidation analysis does not answer questions of substantiability if substantiability applies to partners’ interests in the partnership. substantiability considerations, for example, might prevent “fill-up” allocations where those “fill-up” allocations vary substantially from the long-term economic plan of the partnership. target allocations, properly drafted, usually should be able to explain partners’ interests in the partnership in most cases where substantiability considerations do not intrude.326

Target allocations may fail accurately to describe partners’ interests in the partnership in a variety of situations. These are situations in which target allocations may fail properly to reflect partners’ interests in the partnership.

- Where a partner retires from the partnership, the partnership does not rebook partnership assets, and the target allocation provision operates as a “fill-up” allocation that disproportionately allocates income or loss to the retiring partner.
- Where the target allocation provision allocates only net income and net loss and there is insufficient net income or net loss to cause capital accounts to equal the cash that would be distributed to partners on a constructive sale and liquidation.
- Perhaps where the partnership has a special economic deal with respect to an expense or group of expenses that are funded by a subset of partners.
- Where there are different economic deals with respect to different pools of assets.
- Where there is different sharing of income from operations and gains from sales.
- Where a partner’s control over timing of the liquidation of the partnership or other circumstances can permit the partnership to undertake a shifting distribution scheme that would produce transitory target allocations that fail properly to reflect the partnership’s true economics.
- Where the partnership has entered into contracts that make the target allocations seem to be contrary to true partnership economics.
- The partnership issues restricted partnership interests for services, and the partnership interests are forfeited.
- The partnership has outstanding options to acquire partnership interests.

Of course, there are many situations in which a target allocation provision could fail to comply with partners’ interests in the partnership because the target allocation provisions is not properly drafted.

How do you draft target allocations if target allocation are valuable merely to explain partners’ interests in the partnership? The target allocation provision should be drafted in substantially the same manner that it would be drafted if the target allocation provision controlled tax allocations.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Should target allocations be allocations of net income and loss or gross income and loss? Most of the time, most partnerships satisfactorily allocate net income or net losses. Situations exist in which an allocation of net income will not cause capital accounts to equal the amount that would be distributed to partners in a hypothetical sale and liquidation.

The language of the basic test of partners’ interests in the partnership indicates that the basic test of partners’ interests in the partnership can require gross income allocations under certain circumstances. One possibility, discussed below, is that partners’ interests in the partnership may imply a qualified income offset, which is a special allocation of gross income items. Another situation in which the partnership agreement might require a gross income allocation is where a partner receives a return of invested capital and a preferred return that are preferred to return of capital to another partner.

A good case can be made that the basic test of partners’ interests in the partnership requires allocations of gross income and gross losses when necessary to cause capital accounts to equal the amounts distributed to partners in the hypothetical liquidation. This can be inferred from the language of the basic test of partners’ interests in the partnership and its approval of an allocation of a disproportionate amount of gross income of the partnership to a partner so as to bring that partner’s capital account back up to zero.

Another conjecture is that the target allocation provisions should allocate items of gross income when necessary to cause capital accounts to equal the amount that would be distributed to partners. A further conjecture is that partners’ interests in the partnership implies a qualified income offset.

The Section 704(b) regulations do not provide much of a clue concerning what specific items of income or loss should be allocated to which partner when an allocation under partners’ interests in the partnership becomes an allocation of gross income and loss. Some advisors believe that the partnership or a manager can select items to allocate. This matter, however, is not addressed in the Section 704(b) regulations.

Many target allocation provisions fail specifically to address how the partnership will select specific income or loss items to allocate to a partner. Few partnership agreements provide more precise guidance than to give a manager the discretion to select items to allocate.

327 Treas. Reg. § 1.704-1(b)(3).
328 Treas. Reg. § 1.704-1(b)(3).
All that we can conclude definitely about whether the target allocation provision can affect income and loss allocations is that there is a substantial debate raging in the tax community. That debate does not seem close to resolution.

*Should target allocation provisions be accompanied by qualified income offsets?* The special limited rule for determining partners’ interests in the partnership may have inadvertently left out the reference to a qualified income offset. That is one possibility. A target type allocation or another allocation satisfying the special limited rule for determining partners’ interests in the partnership often would produce results close to the results of the qualified income offset.


330 The qualified income offset could have been drafted simply to eliminate all deficit capital account balances (adjusted by the three adjustments to capital account under the alternative test for economic effect and by minimum gain and partner minimum gain). The Treasury Regulations did not provide for these terms for the qualified income offset.

Both the qualified income offset and the target allocation provision can act on partners with negative capital account balances (adjusted by the three adjustments to capital account under the alternative test for economic effect and by minimum gain and partner minimum gain). The qualified income offset and the target allocation provision will produce similar quantitative results (although there may be character differences) if there is sufficient net income for the year to eliminate adjusted capital account deficits. There can be a subtle differences between the two provisions and arguable differences between the two provisions.

The qualified income offset is a gross income allocation made only to partners who receive unexpected adjustments to capital account of the types described in subparagraphs (4), (5), and (6).

The target allocation provision often is drafted as purely a net income or net loss allocation provision. This, of course, may be in error.

The partnership may have a net loss for the year but it may suffer one of the unexpected adjustments that trigger the qualified income offset. In this partnership agreement, the qualified income offset would apply as a preferential income allocation of gross income, while the target allocation provision would be available only to allocate net losses.

Let us assume, however, that the partnership has a target allocation provision that allocates gross income and gross loss items. Assume that there are not sufficient income items available so that it is possible to adjust each partner’s capital account to equal the amount that the partner would receive on a hypothetical liquidation. The qualified income offset would allocate income items only to the partner who receives the unexpected adjustment. The qualified income offset is (footnote continued on the next page)
The basic test of partners’ interests in the partnership,\(^\text{331}\) however, does require that: “Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in an item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.)”\(^\text{332}\) This is close to a reference to the qualified income offset, which requires gross income allocations in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes the partner to have a negative capital account.

We may have difficulty explaining why “it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.” (Emphasis added.) The qualified income offset perhaps applies a bit differently under partners’ interests in the partnership than it does under the alternate test for economic effect.\(^\text{333}\)

A court that believes in the importance of the qualified income offset in ensuring that allocations conform to partnership economics might imply a qualified income offset for a partnership that does not have one. The considerations are constrained by regulations to allocate “items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year).” The target allocation provision is not clearly subject to this constraint.

Requiring the qualified income offset under partners’ interests in the partnership may be unnecessary. Importantly, there is no mention in the Section 704(b) rules concerning partners’ interests in the partnership of a qualified income offset. This may ground a strong argument that a partnership agreement based on partners’ interests in the partnership should not contain a qualified income offset. The regulations concerning the basic test of partners’ interests in the partnership, however, advise that “in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.”

\(^{331}\) Treas. Reg. § 1.704-1(b)(3).

\(^{332}\) Treas. Reg. § 1.704-1(b)(3)(i).

that suggest the wisdom of requiring a qualified income offset for the alternate test for economic effect\textsuperscript{334} would seem to apply equally to the special limited rule for determining partners’ interests in the partnership.\textsuperscript{335}

A court might conclude that the qualified income offset has no part in the special limited rule for determining partners’ interests in the partnership\textsuperscript{336} – and perhaps also no part of the basic test of partners’ interests in the partnership.\textsuperscript{337} We do not know how this court would account for the language in the regulations that “in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.”\textsuperscript{338}

Without a qualified income offset (or its equivalent), a partner might be able to achieve under the special limited rule for determining partners’ interests in the partnership\textsuperscript{339} whatever tax abuses the qualified income offset was meant to counter.

The language of partners’ interests in the partnership and considerations of tax policy are not sufficiently clear that we can conclude confidently whether a qualified income offset is required – or permitted. The Section 704(b) regulations contain conflicting hints.

\textit{Can a partnership using target allocations and not liquidating in accordance with capital accounts redetermine capital accounts on permitted revaluation events?} The matter of revaluation of assets and redetermination of capital accounts for a partnership not liquidating by capital accounts simply has not been tested. This matter is not expressly addressed by the Section 704(b) regulations. The matter is controversial.

This matter is often important for “fill-up” allocations on the retirement of a partner. Redetermining partnership capital accounts on permitted events is an important principle for allocations that have substantial economic effect.\textsuperscript{340} Capital accounts are critical to the application of substantial economic effect. Capital accounts are critical to the application of substantial economic effect. Capital

\textsuperscript{334} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{335} Treas. Reg. § 1.704-1(b)(3)(ii).
\textsuperscript{336} Treas. Reg. § 1.704-1(b)(3)(iii).
\textsuperscript{337} Treas. Reg. § 1.704-1(b)(3).
\textsuperscript{338} Treas. Reg. § 1.704-1(b)(3)(i).
\textsuperscript{339} Treas. Reg. § 1.704-1(b)(3)(iii).
accounts ultimately determine partnership economics if the partnership agreement has allocations that have substantial economic effect.

The Section 704(b) regulations permit the partnership to revalue assets to fair market value on listed redetermination events\(^\text{341}\) and redetermine capital ac-

---

\(^{341}\) See Treas. Reg. § 1.704-1(b)(2)(iv)(f) (“(f) Revaluations of property. A partnership agreement may, upon the occurrence of certain events, increase or decrease the capital accounts of the partners to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership’s books. Capital accounts so adjusted will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless – (1) The adjustments are based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment, as determined under paragraph (b)(2)(iv)(h) of this section. . . . (2) The adjustments reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date, and (3) The partnership agreement requires that the partners’ capital accounts be adjusted in accordance with paragraph (b)(2)(iv)(g) of this section for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property, and (4) The partnership agreement requires that the partners’ distributive shares of depreciation, depletion, amortization, and gain or loss, as computed for tax purposes, with respect to such property be determined so as to take account of the variation between the adjusted tax basis and book value of such property in the same manner as under section 704(c) (see paragraph (b)(4)(i) of this section), and (5) The adjustments are made principally for a substantial non-tax business purpose – (i) In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership, or (ii) In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership, or (iii) In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004 as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or (iv) In connection with the issuance by the partnership of a noncompensatory option (other than an option for a de minimis partnership interest), or (v) Under generally accepted industry accounting practices, provided substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants.

(footnote continued on the next page)
counts in order to preserve sound partnership economics. The circumstances of these events makes it likely that the partners will be honest in their redetermination of capital accounts.

Capital accounts for a partnership agreement that does not liquidate by capital accounts do not determine partnership economics. A greater opportunity exists for partners to seek to manipulate capital account values when capital accounts do not determine partnership economics. Manipulation of capital accounts can be used to manipulate tax allocations. This suggests that the tax system should have greater skepticism of redetermined capital accounts when the partnership uses a target allocation provision and does not liquidate by capital accounts. Redetermination of capital accounts may have been intended to apply only when capital accounts affect partnership economics on account of liquidation by capital account. Redetermination of capital accounts usually is limited to situations in which there is a “substantial non-tax business purpose” for the redetermination of capital accounts. This issue is not directly addressed in the Section 704(b) regulations.342

The partnership allocation scheme is changed when the partnership redetermines capital accounts on account of an asset revaluation. After the redetermination of capital accounts, the partnership applies principles of Section 704(c) (“reverse Section 704(c) allocations”) to determine allocations of taxable income and loss affected by the revaluation.

The partnership in effect can elect a reverse Section 704(c) allocation scheme by revaluing assets and redetermining capital accounts when its allocations have substantial economic effect. Whether or not the partnership agreement can use capital account redetermination to elect a reverse Section 704(c) regime when the partnership does not liquidate by capital accounts is an uncertain matter.

The Section 704(b) regulations provide only a vague description of partners’ interests in the partnership by listing four factors for determining partners’

342 No explicit restriction on revaluation of assets and redetermination of capital accounts is set forth in the language of the Section 704(b) regulations.
interests in the partnership but without providing guidance concerning how the tax law applies those four factors. We do know that partners’ interests 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.” Many advisors believe that capital account redetermination on permitted revaluation events is necessary in order for allocations best to reflect partnership economics.

Partners’ interests in the partnership perhaps not only permits but may require regular capital account redetermination on permitted revaluation events in order properly to reflect partnership economics. This may permit partnership accounting better to reflect partners’ interests in the partnership than it would if the partnership did not redetermine capital accounts on permitted revaluation events. Regular redetermination of capital accounts on permitted revaluation events thus may be an implied component of partners’ interests in the partnership. (Of course, the tax law may not permit redetermination of capital accounts on these events.) This redetermination of capital accounts may be based on an abstract view of fair market values. This redetermination of capital accounts may not consider partners’ views of what the values of partnership assets are. The matter is speculative.

Can the partnership specially allocate items consistent with using target allocations? Special allocations in the context of partnership agreements that use target allocations are controversial. Some advisors believe that special allocations of tax items can be compatible with target allocations. Other advisors are skeptical.

We could make a reasonably good case that partners’ interests in the partnership tolerates or even requires special allocations under certain circumstances. This can give the partnership agreement using target allocations a limited ability to try to make special allocations of tax items.

This flexibility, at best, however, is closely circumscribed. The economic facts and circumstances must require this special allocation. Beyond this, it is possible that setting forth the special allocation in the partnership agreement will have no tax effect. Partners’ interests in the partnership may operate automatically to specially allocate tax items when partners’ interests in the partnership determines that this is appropriate. The special allocation in the partnership agreement may be no more than descriptive of partners’ interests in the partnership.

The partnership may have an economic arrangement that suggests special allocations. The partnership may have two pools of assets. The partners may have a 90/10 economic sharing ratio with respect to one pool of assets. The partners

---

may have a 50/50 economic sharing ratio with respect to another pool of assets. Another partnership agreement may require that a partner fund all of an expense.\textsuperscript{344}

In both of these cases, that partnership agreement might well have contained special allocations if the partnership agreement had allocations that satisfied the rules of substantial economic effect. The partnership agreement in the first case might have specially allocated the income and loss with respect to the two pools of assets in accordance with the economic sharing ratios. The partnership agreement in the second case might have specially allocated the loss to the partner who funded the losses.

Imagine that the partnership agreement does not contain any allocations at all. Partners’ interests in the partnership might imply special allocations of income and loss with respect to the two pools of assets. The Section 704(b) regulations concerning partners’ interests in the partnership do not provide clear guidance on this point. Partners’ interests in the partnership might merely allocate mixed-together net profits in this situation without special allocations, perhaps using a sale at “book” value and liquidation analysis.

We may have difficulty imaging that partners’ interests in the partnership would allow the partnership merely to select between the two alternatives without anything special in the partnership agreement. One alternative or the other should control in the absence of something special in the partnership agreement.

The tax law could allocate all of the deductions associated with a partnership expense to the partner who economically bears all of the expense. This special allocation may be close to an allocation described in the regulations concerning partners’ interests in the partnership: “Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in an item of income or deduction.”\textsuperscript{345} Partners’ interests in the partnership might specially allocate the deductions from the expense to the partner who bears the expense without any special allocation in the partnership agreement. A strong argument supports the proposition that partners’ interests in the partnership would make this special allocation without any need for a special allocation in the partnership agreement. Part-

\textsuperscript{344} The partnership also might have an economic arrangement where there are different sharing ratios for different partnership profit centers, such as divisions located in different countries.

\textsuperscript{345} Treas. Reg. § 1.704-1 (b)(3)(i).
ners’ interests in the partnership perhaps allocates only net income and net losses. Partners’ interests in the partnership perhaps would not make the special allocation.

The partnership agreement complying with substantial economic effect might not have contained any special allocations.

The language of the basic test of partners’ interests in the partnership\textsuperscript{346} admits the possibility that “Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in an item of income or deduction.”\textsuperscript{347} This suggests the possibility that partners’ interests in the partnership will make special allocations in these two situations, even though special allocations may not be set forth in the partnership agreement. This is a matter of conjecture. Draftsmen preparing target allocation provisions should exercise caution in situations in which the partnership agreement has special economic deals with respect to different classes of assets, generators of cash flow, or expenses. These draftsmen operate in areas of uncertainty concerning partners’ interests in the partnership.

This addresses special allocations that partners’ interests in the partnership might make automatically. A separate question is whether the partnership agreement can describe special allocations while a target allocation provision otherwise governs the partnership. For example, the partnership might specially allocate depreciation deductions to a partner, but otherwise would be controlled by a target allocation provision. A partnership complying with substantial economic effect can make such a special allocation, subject to substantiality concerns.

\textit{Can the partnership make this special allocation expressly in the partnership agreement?} The special allocation in the partnership agreement would have to satisfy partners’ interests in the partnership. Substantial doubt exists that express allocations in the partnership agreement, such as a target allocation provision, will have any effect at all under partners’ interests in the partnership. We have to accept that allocations in the partnership agreement can have some tax effect under partners’ interests in the partnership if the target allocation is going to generally control partnership allocations.

Presuming that the target allocation in the partnership agreement has tax effect under partners’ interests in the partnership, it does not represent a major

\textsuperscript{346} Treas. Reg. § 1.704-1(b)(3).
\textsuperscript{347} Treas. Reg. § 1.704-1(b)(3)(i).
extension of reasoning that some special allocations in the partners’ interests in the partnership could be respected where those special allocations are required to explain partners’ interests in the partnership.

Of course, it is possible that the tax law permits target allocations to control under partners’ interests in the partnership but that partners’ interests in the partnership would automatically imply any special allocations where appropriate. The possibility exists that the tax law allows target allocation provisions in the partnership agreement to define partners’ interests in the partnership generally but that the tax law does not give the partnership agreement any real flexibility in making special allocations of specific tax items, of the results of different pools of partnership assets, or otherwise. This matter has not yet been properly clarified in the tax law.

The partnership agreement might be drafted in such a manner that all of the depreciation with respect to a specific asset reduces distributions to a partner on a dollar-for-dollar basis. (This is an unusual partnership agreement.) A reasonable case could be made under partners’ interests in the partnership that the tax depreciation should be specially allocated to the partner. The draftsman would have to draft the target allocation provisions carefully for the special allocation of depreciation to the partner to be economically meaningful and for the target allocation provisions to work properly.

A special allocation of depreciation should be considerably more difficult to achieve under partners’ interests in the partnership than it is under the economic effect rules. The depreciation deductions should reduce the amount that the partnership would distribute to a partner on liquidation. That will require an unusual partnership agreement if the partnership agreement relies generally on target allocations and does not liquidate in accordance with capital accounts.

Partners’ interests in the partnership likely is considerably more restrictive for partnership agreements that do not liquidate by capital accounts for special allocations. Special allocations under partners’ interests in the partnership must clearly affect partnership economics in order to be respected. That can be a difficult matter to achieve when the partnership does not liquidate in accordance with capital accounts. Separate funding of a partnership expense by a partner could cause deductions associated with that expense to be specially allocated to the partner under partners’ interests in the partnership. A special distribution of profits from a partnership asset to a partner could cause the associated taxable income to be allocated to the partner. Other special allocations in the context of partners’ interests in the partnership require a close analysis of partnership economics.

What adjustments, if any, to capital accounts or to the fund of cash distributed in the hypothetical sale and liquidation should be made for target allocations? The objective is to replicate the economics of a sale of partnership assets at
“book” value and distribution in accordance with the partnership agreement provisions regarding liquidation. Capital accounts for applying target allocations apparently should be adjusted for all “book” items that a partnership would recognize on a sale of all assets at “book” value. This should include minimum gain and partner minimum gain. Capital accounts also should be increased by contributions that partners would be required to make on the constructive liquidation. The hypothetical increases to capital accounts should include hypothetical contributions under capital account deficit restoration obligations and contributions under other obligations.

The nonrecourse deduction regulations do not provide clear guidance concerning the adjustment to adjusted capital accounts for partners’ shares of minimum gain (or partner minimum gain). This is an issue where the partnership does not rebook assets on the retirement of a partner.\textsuperscript{348} The partnership should not have too much difficulty determining the share of minimum gain of continuing partners. A partner may be liquidated during the course of the year. The nonrecourse deduction regulations do not clarify whether the retired partner should receive an adjustment to adjusted capital account on account of the retired partner’s share of minimum gain.

The sensible result would seem to be to treat the retired partner as having a zero share of minimum gain for purposes of applying the target allocation. This means that the target allocation to the retiring partner should charge back the partners’ past nonrecourse deductions.

This matter is unclear in most target allocation provisions, which can cause considerable uncertainty in interpreting these provisions. The nonrecourse deduction regulations are not clear that a retired partner is treated as having a zero share of the minimum gain of the partnership. It similarly is unclear whether the continuing partners will inherit the retired partner’s share of minimum gain.

The fund of cash produced in the hypothetical sale at “book” value perhaps should be reduced by the three downward adjustments to capital account made in applying the alternate test for economic effect.\textsuperscript{349} This is consistent with the application of the special limited rule for determining partners’ interests in the

\textsuperscript{348} The problem goes away when the partnership rebooks assets on the retirement of the partner. The rebooking should eliminate minimum gain.

\textsuperscript{349} One could argue that these adjustments should not be made, since the target allocation provision hypothesizes a liquidation of the partnership in the current year. The capital account adjustments under the alternate test for economic effect reflect future events.
partnership, although the alternate test for economic effect is not expressly mentioned under the basic test of partners’ interests in the partnership.\footnote{350 Treas. Reg. § 1.704-1(b)(3)(iii).}

The fund of cash produced by the hypothetical sale of partnership assets at “book” value also is reduced by partnership liabilities, which are deemed to be satisfied at face. These liabilities should include those liabilities that are recognized as liabilities under Section 752. This modification is consistent with the model that seeks to replicate a hypothetical sale of assets at “book” value and liquidation.

The fund of cash produced by the hypothetical sale of partnership assets at “book” value is increased by partner capital contribution obligations that would be satisfied on the liquidation of the partnership, based on the partnership’s assets (determined at “book” value). This modification also is consistent with the model that seeks to replicate a liquidation of the partnership. Contribution obligations should include contributions under a capital account deficit restoration obligation. Contribution obligations should include contributions under absolute contribution obligations. Contribution obligations could include deemed contributions that a partner would be expected to make to the partnership at liquidation on account of partner-guaranteed partnership debts (or partner-affiliate guaranteed debts) where the partner (or an affiliate) has guaranteed the debts.\footnote{352 See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (“(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which (footnote continued on the next page)\footnote{353 Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3).}} This might include some loans from the partner (or a partner affiliate) to the partnership that would not be repaid on the constructive liquidation and that do not produce minimum gain or partner minimum gain. The target allocation provision should treat the contribution obligations as satisfied. This should increase capital accounts and should increase the assets available for distribution on the hypothetical liquidation.

The Section 704(b) regulations do not provide clear guidance concerning how to deal with contribution obligations that do not meet the timing requirements for payment under the alternate test for economic effect.\footnote{353 Partners’ inter-}

\footnote{353 See Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (“(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which (footnote continued on the next page)\footnote{353 Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3).}}
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ests in the partnership may be more relaxed in its timing requirements than the alternate test for economic effect. This too is a matter of conjecture.

Does a presumption of unlimited partner solvency apply to determining partners’ interests in the partnership? A good case can be made that the presumption of unlimited partner solvency contained in the Section 752 regulations and used to determine which partner bears the economic risk of loss of partnership debt applies for purposes of applying partners’ interests in the partnership and, by extension of reasoning, the analysis of target allocation provisions. The provi-

amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).” Emphasis added."

Treas. Reg. § 1.752-2(b)(6) (“(6) Deemed satisfaction of obligation. For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. See paragraphs (j) and (k) of this section.”).

See, e.g., Treas. Reg. § 1.752-2(a), (b) (“(a) In general. A partner’s share of a recourse partnership liability equals the portion of that liability, if any, for which the partner or related person bears the economic risk of loss. The determination of the extent to which a partner bears the economic risk of loss for a partnership liability is made under the rules in paragraphs (b) through (k) of this section. (b) Obligation to make a payment. (1) In general. Except as otherwise provided in this section, a partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. Upon a constructive liquidation, all of the following events are deemed to occur simultaneously: (i) All of the partnership’s liabilities become payable in full; (ii) With the exception of property contributed to secure a partnership liability (see section 1.752-2(h)(2)), all of the partnership’s assets, including cash, have a value of zero; (iii) The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership); (iv) All items of income, gain, loss, or deduction are allocated among the partners; and (v) The partnership liquidates. (2) Treatment upon deemed disposition. For purposes of paragraph (b)(1)"

(footnote continued on the next page)
of this section, gain or loss on the deemed disposition of the partnership’s assets is computed in accordance with the following: (i) If the creditor’s right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an amount equal to the difference between the amount of the liability that is extinguished by the deemed disposition and the tax basis (or book value to the extent section 704(c) or section 1.704-1(b)(4)(i) applies) in those assets. (ii) A loss is recognized equal to the remaining tax basis (or book value to the extent section 704(c) or section 1.704-1(b)(4)(i) applies) of all of the partnership’s assets not taken into account in paragraph (b)(2)(i) of this section. (3) Obligations recognized. The determination of the extent to which a partner or related person has an obligation to make a payment under paragraph (b)(1) of this section is based on the facts and circumstances at the time of the determination. All statutory and contractual obligations relating to the partnership liability are taken into account for purposes of applying this section, including: (i) Contractual obligations outside the partnership agreement such as guarantees, indemnifications, reimbursement agreements, and other obligations running directly to creditors or to other partners, or to the partnership; (ii) Obligations to the partnership that are imposed by the partnership agreement, including the obligation to make a capital contribution and to restore a deficit capital account upon liquidation of the partnership; and (iii) Payment obligations (whether in the form of direct remittances to another partner or a contribution to the partnership) imposed by state law, including the governing state partnership statute. To the extent that the obligation of a partner to make a payment with respect to a partnership liability is not recognized under this paragraph (b)(3), paragraph (b) of this section is applied as if the obligation did not exist. (4) Contingent obligations. A payment obligation is disregarded if, taking into account all the facts and circumstances, the obligation is subject to contingencies that make it unlikely that the obligation will ever be discharged. If a payment obligation would arise at a future time after the occurrence of an event that is not determinable with reasonable certainty, the obligation is ignored until the event occurs. (5) Reimbursement rights. A partner’s or related person’s obligation to make a payment with respect to a partnership liability is reduced to the extent that the partner or related person is entitled to reimbursement from another partner or a person who is a related person to another partner. (6) Deemed satisfaction of obligation. For purposes of determining the extent to which a partner or related person has a payment obligation and the economic risk of loss, it is assumed that all partners and related persons who have obligations to make payments actually perform those obligations, irrespective of their actual net worth, unless the facts and circumstances indicate a plan to circumvent or avoid the obligation. . . ."
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

sion of unlimited partner solvency is qualified by the Section 752 antiabuse rule\textsuperscript{356} and the general partnership antiabuse rules.\textsuperscript{357} A case nevertheless could be made that partners’ interests in the partnership should inquire into all of the facts and circumstances, which would include the likelihood that a partner can discharge his contribution obligations. If partner solvency is an issue under the basic test of partners’ interests in the partnership,\textsuperscript{358} this could represent a departure of the basic test of partners’ interests in the partnership from the tests of economic effect.

What items (such as nonrecourse deductions, partner nonrecourse deductions, exculpatory deductions, minimum gain chargeback, and partner minimum gain chargeback) should be allocated separately from target allocations? A target allocation provision may not work satisfactorily if the partnership allocates all tax

\textsuperscript{356} Treas. Reg. § 1.752-2(j) ("(j) Anti-abuse rules. (1) In general. An obligation of a partner or related person to make a payment may be disregarded or treated as an obligation of another person for purposes of this section if facts and circumstances indicate that a principal purpose of the arrangement between the parties is to eliminate the partner’s economic risk of loss with respect to that obligation or create the appearance of the partner or related person bearing the economic risk of loss when, in fact, the substance of the arrangement is otherwise. Circumstances with respect to which a payment obligation may be disregarded include, but are not limited to, the situations described in paragraphs (j)(2) and (j)(3) of this section. (2) Arrangements tantamount to a guarantee. Irrespective of the form of a contractual obligation, a partner is considered to bear the economic risk of loss with respect to a partnership liability, or a portion thereof, to the extent that: (i) The partner or related person undertakes one or more contractual obligations so that the partnership may obtain a loan; (ii) The contractual obligations of the partner or related person eliminate substantially all the risk to the lender that the partnership will not satisfy its obligations under the loan; and (iii) One of the principal purposes of using the contractual obligations is to attempt to permit partners (other than those who are directly or indirectly liable for the obligation) to include a portion of the loan in the basis of their partnership interests. The partners are considered to bear the economic risk of loss for the liability in accordance with their relative economic burden for the liability result to the contractual obligations. For example, a lease between a partner and a partnership which is not on commercially reasonable terms may be tantamount to a guarantee by the partner of a partnership liability. (3) Plan to circumvent or avoid the obligation. An obligation of a partner to make a payment is not recognized if the facts and circumstances evidence a plan to circumvent or avoid the obligation. . . .")

\textsuperscript{357} Treas. Reg. § 1.701-2.

\textsuperscript{358} Treas. Reg. § 1.704-1(b)(3).
items (or all “book” items) under the target allocation provision. Allocating partner nonrecourse deductions under a target allocation provision typically is not an agreeable adventure. Partner nonrecourse deductions should be allocated to the partner bearing the economic risk of loss outside of the target allocation provision. The partnership should separately allocate items under a minimum gain chargeback and a partner minimum gain chargeback. Advisors differ on whether it is appropriate to allocate nonrecourse deductions under the target allocation provision. A solution to whether nonrecourse deductions should be allocated under the target allocation provision has not garnered a consensus of opinion. Special allocations of partnership items to a partner may be required under other provisions of the tax law.

**How should the target allocation provision allocate exculpatory deductions?** Exculpatory deductions occupy a nebulous world in partnership taxation. Exculpatory deductions are not expressly addressed in the Section 704(b) regulations. Exculpatory deductions relate to exculpatory debt. Exculpatory debt refers to liabilities that are recourse to the partnership but for which no partner bears the economic risk of loss. Exculpatory debt is not secured by any specific property. Exculpatory debt is recourse to the partnership as an entity. Exculpatory debt is explicitly not recourse to any partner. As exculpatory liabilities may not produce minimum gain and exculpatory deductions may produce negative capital accounts for which no partner bears the economic risk of loss, exculpatory deductions may not allocate neatly under target allocation provisions.

The preamble to Treasury Decision 8327 advises: “Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).”

No guidance is provided concerning how the partnership should “treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).” This statement suggests that the partnership may have somewhat greater flexibility in allocating exculpatory deductions than other deductions. That, however, is not altogether clear. We do not have clear guidance concerning whether exculpatory deductions should be allocated by the target allocation provision or outside of the target allocation provision. We also do not know whether exculpatory deductions are a subset of nonrecourse deductions.

---

359 Exculpatory deductions are discussed in more detail later in this Article.
361 *Query:* what does “explicitly nonrecourse to any partner” mean?
362 *Id.*
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

One of the lingering questions about exculpatory deductions is whether exculpatory deductions should be considered nonrecourse deductions under the Section 704(b) regulations. Exculpatory debt is unsecured and fully recourse to all partnership assets. A reasonable case could be made that exculpatory debt is recourse debt for purposes of the Section 1001 rules. If so, exculpatory debt apparently does not produce minimum gain. This conclusion is contrary to the supposition of the preamble to the nonrecourse deduction regulations, a preamble which appears to assume that exculpatory deductions are nonrecourse deductions. Exculpatory deductions pose a challenge for partnership allocations.

Exculpatory deductions do not produce minimum gain if exculpatory deductions are not nonrecourse deductions. Exculpatory deductions may cause a partner’s capital account to become negative in an amount greater than the partner’s share of nonrecourse deductions if exculpatory deductions are not nonrecourse deductions. This poses a challenge in drafting partnership allocations. Most allocation schemes assume that a partner’s capital account will not be negative in an amount that exceeds the partner’s share of minimum gain and partner minimum gain, plus the partner’s contribution obligations. Exculpatory deductions create the possibility that a partner’s capital account will not be negative in an amount that exceeds the partner’s share of minimum gain and partner minimum gain, plus the partner’s contribution obligations.

Exculpatory deductions are simply allocated as nonrecourse deductions if exculpatory liabilities produce minimum gain. If not, no one is quite sure how exculpatory deductions should be allocated. The typical target allocation provision does not necessarily provide good guidance concerning the allocation of exculpatory deductions. Exculpatory deductions are a challenge for draftsmen of target allocation provisions.

Should nonrecourse deductions be allocated separately from target allocations? As discussed above, this is uncertain. Allocation of nonrecourse deductions under a target allocation provision generally will not qualify for the safe harbor under the nonrecourse deduction allocation rules. The rules concerning

363 Treas. Reg. § 1.704-2(e), (f)(1) (“(e) Requirements to be satisfied. Allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership only if – (1) Throughout the full term of the partnership requirements (1) and (2) of section 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either section 1.704-1(b)(2)(ii)(b) or section 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income (footnote continued on the next page)
allocating nonrecourse deductions where other allocations do not have economic effect are not developed in detail in the nonrecourse deduction regulations. Allocations must be made under partners’ interests in the partnership.

A common practice allocates nonrecourse deductions under a target allocation provision. This approach could be defended as an appropriate application of partners’ interests in the partnership.\(^{364}\) This approach can produce allocations of nonrecourse deductions that shift substantially from year to year when other allocations shift substantially from year to year.

The proper application of partners’ interests in the partnership possibly requires a longer term view, determining the allocation of nonrecourse deductions based on a long-term evaluation of partnership economics. This is merely a conjecture.

Without further guidance from Treasury, the Internal Revenue Service, or the courts, it is difficult in many situations to know how to allocate nonrecourse deductions under partners’ interests in the partnership when the partnership has complex economics that shift from year to year.

\(^{364}\) Reasonable advisors could debate whether this is a correct application of partners’ interests in the partnership.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Should partner nonrecourse deductions be allocated separately from target allocations? Yes. Partner nonrecourse deductions are allocated to the partner bearing the economic risk of loss of these deductions.\(^{365}\)

Should target allocations be accompanied by separate minimum gain chargebacks and partner minimum gain chargebacks? Yes.\(^{366}\)

How should the partnership allocate tax items where a partner retires from the partnership, the partnership does not rebook assets, and the target allocation provision operates as a “fill-up” allocation that disproportionately allocates income or loss to the retiring partner? This is one of the more controversial situations with target allocation provisions. The resolution is not at all certain. “Fill-up” allocations to retiring partners can have the effect of making partnerships potential tax shelter vehicles for the continuing partners. Some advisors argue that the “fill-up” allocation does not properly reflect the economics of the partnership. Other advisors argue that the “fill-up” allocation is a last chance to allocate income associated with built-in gain to the retiring partner.

A partnership can undertake a Section 1031 exchange with taxable boot. One of the partners may retire from the partnership. The taxable “boot” is used to fund the retirement distribution to the retiring partner. The target allocation provi-

\(^{365}\) Treas. Reg. § 1.704-2(i)(1), (2) (“i) Partnership nonrecourse liabilities where a partner bears the economic risk of loss. (1) In general. Partnership losses, deductions, or section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (“partner nonrecourse deductions,’ as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability. (2) Definition of and determination of partner nonrecourse deductions. For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net increase during the year in minimum gain attributable to the partner nonrecourse debt (“partner nonrecourse debt minimum gain”), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. . .”

\(^{366}\) Target allocations may fail accurately to describe partners’ interests in the partnership in a variety of situations. These are situations in which target allocations may fail properly to reflect partners’ interests in the partnership.
sion will allocate net income for the year to the partners so that their capital accounts will equal the amount that they will receive on liquidation. A target allocation provision typically will allocate income from operations and gain disproportionately to the retiring partner if the partnership does not rebook capital accounts on account of the retirement. This allocation under the target allocation provision will allocate both gain from the Section 1031 exchange and other operating income to the retiring partner. Partners often imagine that they simply can allocate “boot” gain from the exchange disproportionately to the retiring partner, but that typically is not the manner in which target allocation provisions operate. The validity of the “fill-up” allocation to a retiring partner after a Section 1031 exchange is an important mystery of partnership taxation. This problem has long been known and little, if any, progress has been made toward resolving the validity of the allocation. The Internal Revenue Service has shown little interest in becoming engaged with this problem.

A variety of considerations favor this disproportionate allocation to the retiring partner. The cash associated with income recognized during the year may be distributed to the retiring partner. This may establish some sort of general conceptual tie between the underlying income and the partner who receives the cash. Many partners feel that it “fair” to allocate the “boot” gain to the partner who receives the cash associated with the “boot” gain. Whether the Internal Revenue Service concurs has not been established. Whether this allocation is in accordance with partners’ interests in the partnership has not been established.

The operation of minimum gain in this context also is uncertain. The target allocation provision typically adds back each partner’s share of minimum gain in computing adjusted capital accounts in applying the target allocation provision. While it would seem that the retiring partner’s share of minimum gain for this purpose should be zero, that is not clear from the nonrecourse deductions regulations. The partner’s share of minimum gain might not be decreased by his retirement from the partnership. Failure to treat the retiring partner as having a zero share of minimum gain in applying the target allocation provision would result in the adjusted capital account of the retiring partner, after the allocations for the year, not equal to the target capital account that the retiring partner will receive in liquidation.\textsuperscript{367} There additionally is an issue of how to apply the minimum gain

\textsuperscript{367} As discussed above, there also is uncertainty in computing the target capital account of the retiring partner. This target capital account might be the amount that the retiring partner would receive under the provision in the partnership agreement for liquidating distributions. It is also possible that the negotiated amount that the partner will receive in retirement should be used as his target capital account.
adjustment to capital accounts for the retiring partner when his interest is retired over several taxable years of the partnership. The retiring partner may have a share of minimum gain for this purpose until the year in which the partner received his final payment in retirement.

The income that target allocation provision allocates to the retiring partner corresponds to the partner’s unrealized appreciation in his partnership interest. The time of retirement of the partner represents a last opportunity for the partnership to allocate to the retiring partner income associated with the unrealized appreciation in his partnership interest. This consideration favors allocating the income associated with the unrealized appreciation in the retiring partner’s capital account to the retiring partner.

The value-equals-basis presumption, if it applies to partners’ interests in the partnership, suggests that the tax system may treat the disproportionate income allocation to the retiring partner as economically real. To some, the disproportionate allocation to the retiring partner represents a surrogate for an overly complex Section 734 basis adjustment. The special allocation, if respected, can substantially accelerate the tax benefits that Section 734 basis adjustments otherwise would produce.

Others are not persuaded by this case. The disproportionate allocation of income to the retiring partner does not reflect true partnership economics. If the partner was a 1/3rd partner before the special allocation, the partner remains a 1/3rd partner and does not have a greater interest in partnership wealth on account of the allocation. The special allocation does not result in any increased distribution to the retiring partner. The retiring distribution is separately negotiated and does not depend economically on the special income allocation.

The strength of the value-equals-basis presumption has not been tested. Some advisors believe that this situation pushes the value-equals-basis presumption to the point of absurdity: the negotiated buy-out price for the retiring partner’s partnership interest is a much better indicator of the value of the partnership’s assets than the “book” value of partnership assets.

The disproportionate allocation to the retiring partner can result in an implied deduction to the partnership of retirement payments that often can exceed the amount distributed to the retiring partner. The retiring partner may pay much less tax on the special allocation than the tax benefit to the continuing partners from the special allocation.

The Internal Revenue Service has remained conspicuously silent on the issue of target allocation provisions and has not entered this debate. Whether the “fill-up” allocation is abusive is a matter that reasonable advisors will debate.

*Can the target allocation provision allocate only net income and net loss and there is insufficient net income or net loss to cause capital accounts to equal*
the cash that would be distributed to partners on a constructive sale and liquidation?

The law is not clear. Many target allocation provisions are based on allocations of net income and net losses. These target allocation provisions do not provide for allocations of gross income and gross losses.

Language in the basic test of partners’ interests in the partnership supports gross item allocations under the target allocation provision when necessary to cause capital accounts to equal liquidation proceeds.

Most of the time for most partnerships, an allocation of net profits and net losses will cause capital accounts to equal liquidation proceeds. A target allocation provision that merely allocates net income and net losses might be satisfactory for these partnerships.

Other partnerships have more unusual situations, such as preferred returns that may require gross item allocations to cause capital accounts to equal liquidation proceeds. The law is not clear on whether these partnerships require gross item allocations. Advisors differ in their views. The Internal Revenue Service and Treasury have not expressed a formal view.

How should the partnership agreement allocate tax items where the partnership has a special economic deal with respect to an expense or group of expenses that are funded by a subset of partners? The language of the basic test of partners’ interests in the partnership supports the conclusion that partners’ interests in the partnership can require special allocations in appropriate circumstances: “this sharing arrangement may or may not correspond to the overall economic arrangement of the partners.” Advisors should not take this as a broad approval of all special allocations under partners’ interests in the partnership.

Partners’ interests in the partnership is supposed to seek “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.” A special economic deal with respect to a pool of assets suggests that income and loss with respect to this pool of assets should be specially allocated. This requirement to make a special allocation if income and loss with respect to this pool of assets should apply whether or not the partnership agreement contains an express allocation. Setting forth special allocations in the partnership agreement does not clearly make any difference.

---

368 Treas. Reg. § 1.704-1(b)(3).
369 Treas. Reg. § 1.704-1(b)(3).
371 Id.
A partnership agreement with target allocations that does not liquidate in accordance with capital accounts typically will liquidate in accordance with a tiered liquidation scheme or a set of percentages. The partnership agreement, however, may differ from this model and provide a different operating cash and liquidation scheme with respect to a separate pool of assets – or perhaps with respect to more than one pool of assets. Special allocations of the associated income or loss in these situations would seem to be appropriate.

A partnership agreement can require that an individual partner, or a smaller group of partners, fund partnership expenses without reimbursement from the partnership. Allocating the corresponding deductions to the partner or partners who bear these expenses would seem to be in accordance with partners’ interests in the partnership, whether or not a special allocation is set forth in the partnership agreement.

A target allocation provision for any of these partnerships that have special economically pooled deals should exclude from the target allocation provision the income or loss that is economically allocated under the special deal. This income or loss should be allocated separately. Clear authority on this issue under partners’ interests in the partnership, however, has not been published by the Internal Revenue Service.

The flexibility of special allocations with target allocation provisions is considerably more circumscribed under partners’ interests in the partnership than it is for allocations that have economic effect. The partnership should have to show that the economics of the separate pool of assets or the partnership item of expense truly are economically specially allocated. This should require a special funding or distribution provision. A partnership that distributes the proceeds of liquidation as a single combined pool normally should not qualify for special allocations of items other than specialized items such as items allocated under the minimum gain chargeback.

How should the partnership handle allocations where a partner’s control over timing of the liquidation of the partnership or other circumstances can permit the partnership to undertake a shifting distribution scheme that would produce transitory target allocations that fail properly to reflect the partnership’s true economics?

A partnership agreement may provide for a liquidation scheme that shifts substantially from year to year. A target allocation provision might disproportionately allocate tax losses in early years based on this allocation scheme. The liquidation scheme might shift in later years so that the allocation of losses to the partner in the earlier years is rendered economically meaningless by later allocations of income. The partner who is allocated early year losses could avoid economical-
ly bearing these losses by ensuring that the partnership does not liquidate until after the liquidation provision shifts in his favor.

Partnership allocations with economic effect that shift from year to year with offsetting allocations in later years can be vulnerable under the substantiality rules.\(^{372}\) The basic test of partners’ interests in the partnership\(^ {373}\) does not expressly mention substantiality considerations. The special limited rule for determining partners’ interests in the partnership\(^ {374}\) references substantiality. This grounds a reasonable argument, stressing considerations of parallelism, that substantiality should apply to the basic test of partners’ interests in the partnership.

---

\(^{372}\) Treas. Reg. § 1.704-1(b)(2)(iii) (“(iii) Substantiality. (a) General rules. Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Notwithstanding the preceding sentence, the economic effect of an allocation (or allocations) 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 such consequences if the allocation (or allocations) were not contained 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 such consequences if the allocation (or allocations) were not contained in the partnership agreement. In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner’s tax attributes that are unrelated to the partnership will be taken into account. . . . The economic effect of an allocation is not substantial in the two situations described in paragraphs (b)(2)(iii)(b) and (c) of this section. However, even if an allocation is not described therein, its economic effect may be insubstantial under the general rules stated in this paragraph (b)(2)(iii)(a). References in this paragraph (b)(2)(iii) to allocations include capital account adjustments made pursuant to paragraph (b)(2)(iv)(k) of this section. References in this paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners’ interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii). . . .”).

\(^{373}\) Treas. Reg. § 1.704-1(b)(3).

\(^{374}\) Treas. Reg. § 1.704-1(b)(3)(iii).
The basic test of partners’ interests in the partnership\textsuperscript{375} perhaps should be applied in a manner that takes substantiality considerations into account. Whether substantiality under the basic test of partners’ interests in the partnership\textsuperscript{376} would operate precisely like the tests of substantiality under the Section 704(b) regulations is a matter of conjecture. Substantiality could be tested differently under partners’ interests in the partnership than under the normal substantiality rules. For example, substantiality might be based under partners’ interests in the partnership on applying fair market value rather than “book” principles.

The partners’ interests in the partnership rules likely should not permit allocations that would fail substantiality if the allocations had economic effect. Exempting partners’ interests in the partnership from substantiality considerations would render substantiality a castle with three high curtain walls and a gaping open back entrance.

\textit{How do target allocations work with partnerships that have issued non-compensatory or compensatory options to acquire partnership interest?} Partnership options create major challenges in drafting target allocation provisions. Regulations mandate specific allocations in connection with noncompensatory and compensatory options.\textsuperscript{377} These special allocations do not easily mesh with target allocations. This requires careful drafting to ensure that the proper special allocations are made.

The issuance of a noncompensatory option (other than an option for a de minimis partnership interest) is a permissible revaluation event.

\textsuperscript{375}Treas. Reg. § 1.704-1(b)(3).

\textsuperscript{376}Treas. Reg. § 1.704-1(b)(3).

34. Drafting the Target Allocation Provision.

We have identified some principles of good target allocations. Most of us would draft the target allocation provisions more or less following the principles of the special limited rule for determining partners’ interests in the partnership\(^{378}\), considering “the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section.”\(^{379}\)

We should consider whether the partnership agreement is just as well served with an allocation provision that provides: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.”

The partnership agreement should provide for a separate allocation of partner nonrecourse deductions,\(^{380}\) minimum gain chargeback, and partner minimum gain chargeback outside of the target allocation provision. The partnership agreement possibly— but not clearly—should provide for a separate qualified income offset outside of the target allocation provision. These matters should not be part of the target allocation provision. The partnership agreement also perhaps should separately allocate exculpatory deductions.

Whether the partnership should separately allocate nonrecourse deductions outside of the target allocation provision is an uncertain matter.\(^{381}\) This will de-

\(^{379}\) Treas. Reg. § 1.704-1(b)(3)(i).
\(^{380}\) The rules for partner nonrecourse deductions require that these deductions be allocated to the partner bearing the economic risk of loss of these deductions. A target allocation provision does not meet this standard. Allocating partner nonrecourse deductions under a target allocation provision is an invitation to misadventure—nearly as bad as an attack by the swarm of bees or the 40 great wolves. A target allocation provision that fails to provide separately for partner nonrecourse deductions could fail to meet the requirements of partners’ interests in the partnership if the partnership has partner nonrecourse deductions.
\(^{381}\) Partnership agreements with target allocation provisions generally do not satisfy the requirements for express allocations of nonrecourse deductions. These

(footnote continued on the next page)
partnership agreements typically fail the requirement of the nonrecourse deduction rules that “[t]hroughout the full term of the partnership requirements (1) and (2) of section 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either section 1.704-1(b)(2)(ii)(b) or section 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset) . . . .” Treas. Reg. § 1.704-1(b)(3)(i). The target allocation provision arguably defines “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.” Treas. Reg. § 1.704-1(b)(2)(iii). Furthermore, the target allocation may define partners’ interests in the partnership. The nonrecourse deduction regulations provide that “nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership.” Treas. Reg. § 1.704-2(a)(1) (“Thus, nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners’ interests in the partnership. If that test is not satisfied, the partners’ distributive shares of nonrecourse deductions are determined under section 1.704-1(b)(3), according to the partners’ overall economic interests in the partnership.”).

This creates a drafting challenge. The regulations concerning nonrecourse deductions say that “[a]llocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership only if the express requirements of the nonrecourse deduction rules are satisfied.” This presumably means that the target allocation provisions will have no direct effect on allocating nonrecourse deductions. A partnership agreement containing a target allocation provision normally does not satisfy these rules.

The nonrecourse deduction regulations provide no guidance concerning how the partnership allocates nonrecourse deductions when the terms for allocating nonrecourse deductions are not meant. This puts the draftsman in a bit of a quandary. Does he include nonrecourse deductions under the target allocation provision knowing that the nonrecourse deduction regulations say that he has not satisfied the requirements for allocating nonrecourse deductions or does he exclude nonrecourse deductions from the items allocated under the target allocation provision? The author believes that the partnership agreement is cleaner if both nonrecourse deductions and partner nonrecourse deductions are excluded from the target allocation provisions.

(footnote continued on the next page)
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Pend on the judgment of the draftsman until the law is further clarified. If nonrecourse deductions are allocated outside of the target allocation provision, it is possible that the target allocation provision will allocate a net profit in a year in which the partnership has a net loss when nonrecourse deductions are included in computing that net loss.

The allocation of exculpatory deductions inside or outside the target allocation provision will depend on the judgment of the draftsman. The allocation of exculpatory deductions currently is in such a state of uncertainty that there are substantial differences in judgment concerning how exculpatory deductions should be allocated. The partnership agreement should allocate partner nonrecourse deductions separately from the target allocation provision.


We need to capture the nuances of the hypothetical sale at “book” value and liquidation in drafting the target allocation provision if we believe that this is

Other draftsmen, however, may prefer to include nonrecourse deductions in items allocated under the target allocation provision. Only the future will tell which approach is correct.

The target allocation provision that merely allocates taxable income or loss does not work well if the partnership has a “book”-tax disparity. The draftsman of the target allocation provision should be careful to draft the target allocation provision as an allocation of “book” income and not as a direct allocation of taxable income and loss. Actual tax allocations are determined under Section 704(c) principles or reverse Section 704(c) principles after the partnership determines “book” allocations under the target allocation provision.

The law is uncertain whether the target allocation provision should allocate net “book” items or gross “book” items. If the target allocation provision allocates gross “book” items, the target allocation provision should clarify what items the partnership allocates to which partner – or, at least, should provide a mechanism for selecting what “book” items should be allocated to each partner. The tax law might approve some target allocation provisions as allocating net items, when the tax law might require allocations of gross items for other partnerships. All of this is left to the future to determine.
a correct interpretation of the basic test of partners’ interests in the partnership.\footnote{383} When a partner retires from the partnership during the current taxable year, this poses the question of whether the target allocation provision should treat the retiring partner as receiving the amount that he would receive on normal liquidation under the partnership agreement or the amount provided for under the retirement agreement. Many target allocation provisions appear to treat the retiring partner as receiving the amount that he would receive under the normal liquidation provisions of the partnership agreement (the target) rather than the amount that he will receive under the retirement agreement. This would seem not to reflect partners’ interests in the partnership properly. Disregarding the amount that the retiring partner receives under the retirement agreement would seem to ignore economic reality. It would seem more appropriate that the target for a retiring partner should be based on the amount that the partner is paid in retirement. That nevertheless may not be what many target allocation provisions seem to say.

Some things occur in the hypothetical sale and liquidation:

- The partnership sells all of its assets for “book” value (or for the amount of nonrecourse debt, in the case of a property with nonrecourse debt in excess of “book” value). That should produce a fund of cash.

- The cash from the sale increases capital accounts and also increases the fund of cash that the partnership would have to distribute in liquidation.

- The partnership pays off its debts. That reduces the fund of cash produced by the hypothetical sale of partnership assets at “book” value.

- Any cash that a partner would be expected to contribute on account of contribution obligations as a result of the liquidation should increase capital accounts.\footnote{384}

- The fund of cash available for distribution to the partners on liquidation may be reduced by the capital account adjustments under the alternate test for economic effect.\footnote{385}

\footnote{383} We also need to be mindful that it is merely conjecture that the hypothetical sale at “book” value and liquidation is the basis for applying partners’ interests in the partnership under the basic test of partners’ interests in the partnership.\footnote{384} That cash increases capital accounts and also increases the fund of cash that the partnership would have to distribute in liquidation.
Gain is potentially recognized under the minimum gain chargeback and the minimum gain chargeback should increase capital accounts. That gain adjusts capital accounts. 386

Cancellation of indebtedness income may result from exculpatory debt that would be unpaid in the transaction. That gain would increase capital accounts.

Various contribution obligations can increase the fund of cash available for liquidating distributions (and also increase partner capital accounts in the hypothetical sale and liquidation analysis):

- Absolute contribution obligations increase cash available for liquidating distributions. 387
- Capital account deficit restoration obligations increase cash available for liquidating distributions to the extent that partners would have deficit capital accounts after the hypothetical sale and allocation of gain or loss from the hypothetical sale – and would be expected to fund these deficits. 388

This matter is uncertain, but a good case can be made for these adjustments.

The target allocation provision can be drafted on a prerecognition or postrecognition basis.

The basic test of partners’ interests in the partnership might consider as contribution obligations only those obligations that are deemed to be satisfied within the timing limitations of the alternate test for economic effect. A respectable argument can be made for considering only these obligations in order to provide greater parallelism between the alternate test for economic effect and partners’ interests in the partnership.

The presumption under the Section 752 regulations that a partner will satisfy his obligations regardless of partner solvency likely will apply for this purpose. The basic test of partners’ interests in the partnership possibly considers a partner’s solvency in considering the amount that the partner would contribute in the hypothetical sale and liquidation. The antiabuse rule under Section 752 can disregard repayment obligations. This antiabuse provision may apply in determining how the partnership allocates losses under partners’ interests in the partnership in appropriate situations.

This requires consideration of whether the hypothetical sale at “book” value would leave a partner with a “book” capital account that is negative. A partner might have an obligation that would be treated as a limited capital account deficit restoration obligation under the alternate test for economic effect (a real contribu-

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Partner (or affiliate) loans to the partnership might be treated as contribution obligations to the extent that those loans would be unsatisfied on the liquidation.\textsuperscript{389}

\footnote{This requires an analysis of the solvency of the partnership after the sale at “book” value. Partnership cash must be apportioned among its various liabilities if the partnership is insolvent on a “book” value basis. This requires a legal analysis of the liquidation. The analysis of this is uncertain. Partner loans also might meet the definition of “partner nonrecourse debt.” See Treas. Reg. § 1.704-2(b)(4) (“(4) Definition of partner nonrecourse debt. “Partner nonrecourse debt” or “partner nonrecourse liability” means any partnership liability to the extent the liability is nonrecourse for purposes of section 1.1001-2, and a partner or related person (within the meaning of section 1.752-4(b)) bears the economic risk of loss under section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.”). The law is unclear that a partner loan to the partnership can be nonrecourse for purposes of Treas. Reg. § 1.1001.2. If the loan is partner nonrecourse, it might be considered a deemed contribution obligation on account of minimum gain or partner minimum gain. The partner would be expected to satisfy the limited capital account deficit restoration obligation with a contribution on liquidation only if the partner ends up with a deficit capital account in the sale at “book” value and liquidation model. The partner would not be treated as satisfying the limited capital account deficit restoration obligation if the partner ends up with a positive capital account in the sale at “book” value and liquidation model. Many target allocation provisions neglect this point and add back all limited capital account deficit restoration obligations to capital accounts, regardless of whether the limited capital account deficit restoration obligations would be expected to be satisfied in the sale at “book” value and liquidation model. The target allocation provision should have the flexibility to treat a partner as satisfying his limited capital account deficit restoration obligation if he has a negative capital account at liquidation (to the extent that the economics suggest that the partner would satisfy the limited capital account deficit restoration obligation at liquidation), but not to satisfy his limited capital account deficit restoration obligation if he has a positive capital account at liquidation (to the extent that the economics suggest that the partner would not satisfy the limited capital account deficit restoration obligation at liquidation). A target allocation provision that increases capital accounts by “the amount, if any, that such Partner is obligated (or deemed obligated) to contribute, in its capacity as a Partner, to the partnership, computed immediately prior to the hypothetical sale of assets” does not necessarily provide proper guidance concerning partners’ interests in the partnership. We do not know whether partner solvency is considered in evaluating partner contribution obligations. On deficit restoration obligations, see Rev. Rul. 97-38, 1997-2 C.B. 69.\textsuperscript{389} (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Partner (or affiliate) guarantees of partnership loans might be treated as contribution obligations to the extent that those loans would be treated as unsatisfied on liquidation.\(^{390}\)

- Partner (or affiliate) pledges of property to secure partnership loans might be treated as contribution obligations to the extent that the partner (or affiliate) would be considered to bear the economic risk of loss of the loans at liquidation.\(^{391}\)

Various adjustments are made to partner capital accounts on account of the hypothetical sale, including these adjustments:

- Partner contributions that would be expected at liquidation should both increase partners’ capital accounts and increase the fund of cash that would be available to distribute at liquidation.

- The hypothetical sale should cause the minimum gain chargeback and the partner minimum gain chargeback to apply to adjust capital accounts.\(^{392}\)

- Cancellation of indebtedness income may result from exculpatory debt that would be unpaid in the transaction. That gain would increase capital accounts.

\(^{390}\) See note 389.

\(^{391}\) See note 389.

\(^{392}\) The target allocation provision should be drafted carefully so that there is no double counting of partner minimum gain and that amount should not be treated as a potential capital contribution to the partnership. The law concerning partnership loans where partners have direct or indirect repayment obligations is not well settled.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The reader is left to make of these considerations what he will. The reader will have to draft his own target allocation provision – or to rely on a target allocation provision that he has pinched from someone else. Alternatively, the reader can rely on an allocation provision as simple as this: “The partnership will allocate all items of income, gain, loss, and deduction in accordance with partners’ interests in the partnership.” Using this provision avoids the need to draft a complex target allocation provision.

The draftsman drafting a general purpose target allocation provision should consider these challenges:

- How does the target allocation provision handle nonrecourse indebtedness in excess of the “book” value of the security?
- How does the target allocation provision handle nonrecourse deductions?
- How does the target allocation provision handle partner nonrecourse deductions?
- How does the target allocation provision handle exculpatory deductions?
- How does the target allocation provision handle the minimum gain chargeback?
- How does the target allocation provision handle the partner minimum gain chargeback?
- How does the target allocation provision handle special adjustments to capital account under the alternate test for economic effect?\(^{393}\)
- How does the target allocation provision handle events that might cause a qualified income offset to apply if the partnership agreement contained a qualified income offset?
- How does the target allocation provision operate when the partnership retires a partner with a positive capital account?
- How does the target allocation provision operate when the partnership retires a partner with a substantial negative capital account?

\(^{393}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- How does the target allocation provision operate when a return of capital and return on capital to one partner are preferred to return of capital to another partner?
- How does the target allocation provision operate when the partnership has different economic deals with respect to different assets or different pools of assets?
- How does the target allocation provision operate when the partnership has different economic deals with respect to different divisions or business locations?
- How does the target allocation provision operate when one partner funds and bears a partnership expense?
- How does the target allocation provision work when the partners have different sharing ratios for cash from operations and for cash from capital events?
- How does the target allocation provision operate when the partnership does not have enough net profits or net losses to cause capital accounts to equal the amount that will be distributed to each partner in the hypothetical sale at “book” value and liquidation?
- How does the target allocation provision operate when a partner has an obligation to make additional capital contributions to the partnership at liquidation?
- How does the target allocation provision operate when a partner (or a partner affiliate) guarantees a loan to the partnership?
- How does the target allocation provision operate when a partner (or a partner affiliate) pledges partner (or partner affiliate) property to secure a loan to the partnership?
- How does the target allocation provision operate when a partnership has anticipated or unexpected future depletion?
- How does the target allocation provision operate when a partnership has anticipated or unexpected future cash dis-attributions in excess of income?
- How does the target allocation provision operate when a partnership has an anticipated or unexpected future allocation of income and loss under Section 706(d)?
- How does the target allocation provision operate when a partnership agreement handle the possibility of re-determination of capital accounts on permitted revaluation events?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Is a target allocation provision more vulnerable under partners’ interests in the partnership if the partnership agreement is amended to add the target allocation provision immediately before an event that causes a large preferred allocation under the target allocation provision?

- How should the target allocation provision deal with exculpatory deductions and income allocations that charge back prior exculpatory deductions?

- How should the target allocation provision be drafted to take into account required corrective allocations on account of partnership options?  

\[394\] Treas. Reg. § 1.704-1(b)(4)(x) (corrective allocations). The preamble provides: "The proposed regulations require the partnership to make corrective allocations of gross income or loss to the partners in the year in which the option is exercised so as to take into account any shift in the partners’ capital accounts that occurs as a result of a capital account reallocation pursuant to the exercise of a noncompensatory option. Corrective allocations are allocations of tax items that differ from the partnership’s allocations of book items. If there are not sufficient actual partnership items in the year of exercise to conform the partnership’s tax allocations to the capital account reallocation, additional corrective allocations are required in succeeding taxable years until the capital account reallocation has been fully taken into account.

". . . The Treasury Department and the IRS considered other alternatives but believe that corrective allocations are the most administrable alternative means to address the potential problem of income shifting when, prior to the exercise of a noncompensatory option, a partnership recognizes gain or loss that is, in part, economically attributable to the option holder, but is allocated entirely to the existing partners. Therefore, the final regulations retain the requirement for corrective allocations in certain circumstances.

. . .

"The final regulations require corrective allocations to be made so as to take into account any capital account reallocation upon exercise of a noncompensatory option. Therefore, partnership items may be correctly allocated to the exercising option holder only of items properly allocable to a partner that suffered a capital account reduction and only to the extent such partner suffered a capital account reduction. This approach may result in corrective allocations not being fully made if a partner that suffered a capital account reduction on exercise is no longer a partner in the issuing partnership at the time a corrective allocation would otherwise be made.

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The proposed regulations provide that corrective allocations are pro rata allocations of gross income and gain or gross loss and deduction. The proposed regulations do not require any matching of character between the income or loss that is correctly allocated, and gains or losses that were allocated to existing partners prior to the option’s exercise, but that were economically attributable to the option holder. Additionally, some commenters requested guidance on making corrective allocations in a year in which the partnership has both gross income and gain and gross loss and deduction. In some cases, a corrective allocation that completely takes into account the capital shift may not be possible in a given year if only gross income and gain, or gross loss and deduction, are used. However, commenters noted that it may be possible to more fully take into account the capital shift if corrective allocations are made using a combination of gross income and gain and gross loss and deduction. The Treasury Department and IRS agree that combinations of gross income and gain and gross loss and deduction should be available for corrective allocations.

Accordingly, the final regulations provide a mechanism for making corrective allocations using combinations of gross income and gain and gross loss and deduction in certain circumstances. If the capital account reallocation is from the historic partners to the exercising option holder, then the corrective allocations must first be made with gross income and gain. If an allocation of gross income and gain alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross loss and deduction as to further take into account the capital account reallocation. Conversely, if the capital account reallocation is from the exercising option holder to the historic partners, then the corrective allocations must first be made with gross loss and deduction. If an allocation of gross loss and deduction alone does not completely take into account the capital account reallocation in a given year, then the partnership must also make corrective allocations using a pro rata portion of items of gross income and gain as to further take into account the capital account reallocation.” T.D. 9557, REG-106918-08 (Feb. 5. 2013).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- How should the target allocation provision deal with the effects of a compensatory partnership interest?\textsuperscript{395}
- How should the target allocation provision deal with retroactive commencement date of a service partnership interest?

35. Drafting for Exculpatory Deductions.

Most partnership agreements ignore exculpatory deductions. Exculpatory deductions may require special drafting care. Exculpatory deductions to a surprising extent have been ignored by partnership agreement draftsmen. Simplicio does not consider exculpatory deductions in drafting his partnership agreements. Exculpatory deductions provide Simplicio with abundant opportunities to make mistakes. Exculpatory deductions may provide one of the greatest challenges in drafting partnership allocations – or exculpatory deductions may be nothing more than a special case of nonrecourse deductions that is subject to normal nonrecourse deduction rules.

Salviati carefully considers exculpatory deductions and corresponding income. Salviati, however, has not determined quite how to allocate exculpatory deductions. As an interim measure, Salviati provides that, exculpatory deductions are allocated in accordance with partners’ interests in the partnership to the extent that exculpatory deductions are not nonrecourse deductions.

“Exculpatory deductions” are deductions attributable to exculpatory liabilities. That much is clear. “Exculpatory liabilities” are partnership debt where the debt is not secured by any specific property and the debt is recourse to the part-

\textsuperscript{395} See, generally, REG-105346-03, 70 Fed. Reg. 29675-29683 (2005). This published proposed regulations concerning the receipt of a compensatory partnership interest. The proposed regulations require that any deduction on account of the admission of a service partner be allocated to the continuing partners. The proposed regulations also require forfeiture allocations on the forfeiture of a compensatory interest that is subject to a substantial risk of forfeiture. Forfeiture allocations are allocations to the service provider of partnership gross income and gain or gross deduction and loss (to the extent such items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. A forfeiting partner must be allocated partnership income to offset any distributions to the partner that reduced the partner’s basis in the partnership below the amount included in income under Section 83(b). Currently, it appears that the compensatory partnership interest regulations are being held in abeyance until Congress resolves the taxation of service partnership interests.
partnership as an entity, but explicitly not recourse to any partner. \(^{396}\) Exculpatory liabilities most typically are recourse obligations of LLCs. Exculpatory deductions may be subject to special allocation rules. These rules may give the partnership draftsman increased drafting discretion. It nevertheless is not clear that anyone knows what rules control allocations of exculpatory deductions.

No one seems to understand the fine texture – or perhaps even the rough texture – of the rules that apply to allocating exculpatory deductions. The current rules concerning exculpatory deductions may be so uncertain in the absence of clearly controlling Treasury Regulations that any special allocations of exculpatory deductions may be unsafe and inadvisable.

One can propose rules concerning how he or she thinks that exculpatory deductions should be allocated. \(^{397}\) Precisely how Treasury and the Internal Revenue Service thinks that exculpatory deductions should be allocated is not clear. For that matter, there is no clear guidance concerning what deductions are exculpatory deductions.

Many advisors simply assume that exculpatory deductions are nonrecourse deductions. That is a matter for the future to resolve. Exculpatory deductions may merely be nonrecourse deductions. Then, exculpatory deductions are simply allocated under nonrecourse deduction rules. Allocations of nonrecourse deductions under the nonrecourse deduction regulations often is not certain when partnership agreements fail to satisfy substantial economic effect. \(^{398}\) It also is possible that

\(^{396}\) It could easily be argued that exculpatory liabilities are any liabilities that are fully recourse to the partnership and its assets but completely nonrecourse to the partners and their assets.

\(^{397}\) See, e.g., Karen Burke, “Exculpatory Liabilities and Partnership Nonrecourse Allocations,” 57 Tax Lawyer 33 (2003). Notwithstanding comments in the Preamble to Treasury Decision 8385, 56 Fed. Register 66978-66995 (December 27, 1991), it is not clear whether the basic nature of exculpatory deductions is nonrecourse deductions or recourse deductions. Advisors also should consider the uncertain treatment of deductions allocable to partnership liabilities that are full recourse to the partnership, nonrecourse to the partnership, and that are unsecured. These deductions apparently are not exculpatory deductions, but these deductions post much the same problems.

\(^{398}\) Treas. Reg. § 1.704-2(b)(1) (“(b) General principles and definitions. (1) Definitions of and allocations of nonrecourse deductions. Allocations of losses, deductions, or section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (“nonrecourse deductions”) cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the

(footnote continued on the next page)
exculpatory deductions never are nonrecourse deductions. Then, we do not know how exculpatory deductions are allocated.

partners’ interests in the partnership. Paragraph (e) of this section provides a test that deems allocations of nonrecourse deductions to be in accordance with the partners’ interests in the partnership. If that test is not satisfied, the partners’ distributive shares of nonrecourse deductions are determined under section 1.704-1(b)(3), according to the partners’ overall economic interests in the partnership. See also paragraph (i) of this section for special rules regarding the allocation of deductions attributable to nonrecourse liabilities for which a partner bears the economic risk of loss (as described in paragraph (b)(4) of this section).”); Treas. Reg. § 1.704-2(e), (f)(1) (“(e) Requirements to be satisfied. Allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership only if – (1) Throughout the full term of the partnership requirements (1) and (2) of section 1.704-1(b)(2)(ii)(b) are satisfied (i.e., capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either section 1.704-1(b)(2)(ii)(b) or section 1.704-1(b)(2)(ii)(d) is satisfied (i.e., partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset); (2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, partnership agreement provides for allocations of nonrecourse deductions 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; (3) Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, the partnership agreement contains a provision that complies with the minimum gain chargeback requirement of paragraph (f) of this section; and (4) All other material allocations and capital account adjustments under the partnership agreement are recognized under section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under section 613A(c)(7)(D) are recognized under section 1.704-1(b)(4)(v)). (f) Minimum gain chargeback requirement. (1) In general. If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).”).
The exceptional feature of exculpatory deductions is that, if exculpatory
deductions are not nonrecourse deductions, it seems that exculpatory
deductions do not create minimum gain. The failure of exculpatory deductions to produce
minimum gain can result in partners without capital account deficit restoration
obligations having deficit capital accounts with deficit balances greater than the
partners’ shares of minimum gain and partner minimum gain. Indeed, it is very
possible that the partnership will not have exculpatory deductions until the part-
ners’ aggregate capital accounts (increased by partners’ shares of minimum gain
and partner minimum gain) are reduced to zero. This creates an analytical quanda-
ry. The rules of nonrecourse deductions are dependent on minimum gain. The
rules of economic effect are based on a partner bearing the economic risk of loss
of loss allocations. Exculpatory deductions may not create minimum gain and no
partner may bear the economic risk of loss of exculpatory liabilities.

Rules applying to allocation of exculpatory deductions have not been cla-
1rified in Treasury Regulations or other authority. Treasury and the Internal Re-
v1enue Service badly need to undertake a Treasury Regulations project that addresses
exculpatory deductions and other deductions allocable to liabilities that are full
recourse to the partnership and nonrecourse to the partners. Exculpatory deduc-
tions may have certain aspects of nonrecourse deductions as the exculpatory debt
is nonrecourse under Section 704. Exculpatory deductions may have elements of
recourse deductions. The exculpatory debt may be recourse under Section 1001.
Exculpatory deductions may not behave in an orderly manner under either a non-
recourse deduction regime or a recourse deduction regime.

Exculpatory deductions may not create minimum gain. No partner bears
the economic risk of loss of exculpatory deductions. Treasury and the Internal
Revenue Service may need to develop wholly new rules to govern allocations of
exculpatory deductions and deductions attributable to secured debt that is full re-
course to the partnership and nonrecourse to the partners.

A whole world of exculpatory deductions seems to be based on a single
paragraph from Treasury Decision 8385. Tax advisors, Treasury, and the Internal
Revenue Service have not much explored this world. Advisors should be care-
ful. The critical paragraph in the Treasury Decision 8385 describing exculpat-

399 It is not clear that a distinction should be made between secured and unse-
cured obligations where the obligations are full recourse to the partnership and
nonrecourse to the partners and related persons.

400 Preamble to Treasury Decision 8385, 56 Fed. Register 66978-66995 (De-

401 Preamble to Treasury Decision 8385, 56 Fed. Register 66978-66995 (De-
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

ry deductions and exculpatory liabilities may not have been properly thought through by the authors of that paragraph.

a. What Are Exculpatory Liabilities?

Exculpatory deductions are funded by exculpatory liabilities. Treasury Decision 8385 promulgated the final Nonrecourse Deduction Regulations on December 27, 1991.402 A paragraph in Treasury Decision 8385 provides:

B. MINIMUM GAIN CALCULATIONS FOR EXCULPATORY LIABILITIES.

A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. Under that definition, an exculpatory liability is a nonrecourse liability. The application of the nonrecourse debt rules of section 1.704-2 — more specifically, the calculation of minimum gain — may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached to the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b). Commentators have requested that the treatment of allocations attributable to exculpatory liabilities under the nonrecourse debt rules be clarified. The Service and the Treasury solicit further suggestions on the appropriate treatment of allocations attributable to these liabilities. Suggestions should take into account the practical concerns of partnerships as well as the Service's concerns about the proper allocation of loss and gain items attributable to these liabilities. 403

Advisors and taxpayers might have preferred clearer guidance than: “Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).”

These comments apparently are the foundation of the law of exculpatory liabilities and exculpatory deductions, to the extent that any foundation exists. Neither the Code nor the Treasury Regulations refer explicitly to exculpatory liabilities or to exculpatory deductions. The Preamble to Treasury Decision 8385404


403 Id. Note that secured debt cannot constitute exculpatory liabilities. A debt that has recourse only to a pool of assets, but not all assets of the partnership, similarly cannot constitute an exculpatory liability.

advise: “The application of the nonrecourse debt rules of section 1.704-2 – more specifically, the calculation of minimum gain – may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached to the lender in the case of an exculpatory liability may fluctuate greatly.” That comment is of limited aid to taxpayers and their advisors. The Internal Revenue Service has done nothing since Treasury Decision 8385 to clarify the tax treatment of exculpatory deductions. Unsecured partnership debt that is recourse to all partnership assets and nonrecourse to the partner may not produce minimum gain at all. That would increase the complexity of dealing with exculpatory deductions. No partner bears the economic risk of loss of unsecured partnership debt that is recourse to all partnership assets and nonrecourse to the partners.

Exculpatory liabilities perhaps should be nonrecourse to the partners and also nonrecourse to their related persons, although this is not clear from Treasury Decisions 8385. A liability that is recourse to a partner but where the partner is not treated as bearing the economic risk of loss of the liability under the de minimis partner rules perhaps also should be treated as an exculpatory liability, although this also is not clear from Treasury Decision 8385. Exculpatory liabilities perhaps should follow the economic risk of loss rule for recourse liabilities.

---

406 Treas. Reg. § 1.752-2(d) (“(d) De minimis exceptions. (1) Partner as lender. The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). (2) Partner as guarantor. The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

We can glean these observations from Treasury Decision 8385 concerning exculpatory deductions (at least based on the term “exculpatory liabilities” as used in Treasury Decision 8385):

- An exculpatory liability (or exculpatory liability) is debt with these characteristics –
  - The debt is not secured by any specific property.  
  - The debt is recourse to the partnership as an entity.  
  - The debt is explicitly not recourse to any partner.
- An exculpatory liability is nonrecourse debt for purposes of Section 704 – and Section 752. This follows from the fact that no partner has liability on the exculpatory liability.
- None of the partners should bear the economic risk of loss of the exculpatory liability, either directly or indirectly.
- None of the partners should bear the economic risk of loss of the exculpatory liability upon a liquidation of the partnership.

We can speculate on these principles that perhaps should be added to Treasury Decision 8385:

- A liability is an exculpatory liability only if no partner bears the economic risk of loss of the liability under the rules of Section 752.
- A liability that is recourse to a partner or to a person related to a partner can be an exculpatory liability only if the de minimis partner rules apply.  

---

408 This would seem to mean that the debt is not secured at all – or that no property is pledged as security for the debt. We can debate the effects of an unperfected pledge of property. We also can debate the effects of equitable interests such as a vendor’s lien. Query: why is it important that the liability be unsecured? What is the tax treatment of liabilities that are secured by partnership property but that are recourse to all partnership assets but nonrecourse to the partners?
409 This very possibly makes the liability recourse for purposes of Section 1001.
410 Query: why is it important that the debt be “explicitly” nonrecourse? What does it mean to be “explicitly” nonrecourse?
411 See Treas. Reg. § 1.752-2(d).
The status of partnership liabilities that are fully recourse to a partner but where the partner is treated as not bearing the economic risk of loss of the liability under the *de minimis* partner rules is uncertain. These liabilities are nonrecourse liabilities for purposes of Section 704 and Section 752. Whether these liabilities produce minimum gain is a matter of conjecture.

Treasury Decision 8385 strongly suggests that exculpatory liabilities can produce minimum gain. Treasury Decision 8385 does not provide any details concerning how exculpatory liabilities produce minimum gain. This certainly does not work like traditional well-behaved nonrecourse liabilities that are secured by specific partnership property.

The application of the Nonrecourse Deduction Regulations – especially the calculation of minimum gain – may be difficult in the case of exculpatory liabilities. This difficulty results because –

- The debt is not secured by specific property.
- It is not clear that exculpatory liabilities “encumber” partnership property.
- The bases of partnership properties that can be reached by the lender in the case of exculpatory liabilities may fluctuate greatly.
- Minimum gain may depend on the debt being secured by (or at least encumbering) partnership property.

---

412 See Treas. Reg. § 1.752-2(d).

413 Treas. Reg. § 1.704-2(b)(2) (“(2) Definitions of and allocations pursuant to a minimum gain chargeback. To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (“partnership minimum gain”) . . .”). Compare Treas. Reg. § 1.704-2(b)(2) with Treas. Reg. § 1.704-2(d) (“(d) Partnership minimum gain. (1) Amount of partnership minimum gain. The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the part-

(footnote continued on the next page)
Exculpatory liabilities may not produce minimum gain.

The extraordinary characteristic of exculpatory liabilities is that no partner bears the economic risk of loss of exculpatory liabilities (including the economic risk of loss on a liquidation of the partnership) and exculpatory liabilities may not produce minimum gain. The normal allocation mechanism for recourse deductions is based on who bears the economic risk of loss of the underlying deductions. This is based on who has funded the contributions that funded the deductions or who bears the economic risk of loss of the recourse debt that has funded the deductions. No clear principle anchors the analysis of to whom the partnership should allocate exculpatory deductions or to whom the partnership should allocate income associated with exculpatory liabilities. This lack of clear analytical princi-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Ples makes dealing with exculpatory deductions and income attributable to exculpatory liabilities all the more difficult.

Treasury Decision 8385\footnote{Preamble to Treasury Decision 8385, 56 Fed. Register 66978-66995 (December 27, 1991).} includes as exculpatory liabilities only liabilities that are unsecured. A good case can be made that rules concerning exculpatory liabilities should be extended to partnership liabilities that are secured, full recourse to the partnership, and nonrecourse to the partners and their related persons.

Treasury Regulations Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers are left to treat allocations attributable to these debts in a manner that reasonably reflects the principles of Section 704(b). What that may mean in the context of exculpatory deductions is obscure.

This is the definition of “nonrecourse liabilities” under Section 752:

\begin{quote}
(2) Nonrecourse liability defined. A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under section 1.752-2.\footnote{Treas. Reg. § 1.752-1(a)(2).}
\end{quote}

No partner bears the economic risk of loss of exculpatory liabilities. Exculpatory liabilities are “nonrecourse liabilities” under Section 752. That much is clear.

The next stop in the analysis is the definition of “nonrecourse debt” under Section 704:

\begin{quote}
(3) Definition of nonrecourse liability. “Nonrecourse liability” means a nonrecourse liability as defined in section 1.752-1(a)(2) or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after June 24, 2003.\footnote{Treas. Reg. § 1.704-2(b)(3).}
\end{quote}

This definition should leave no material doubt that exculpatory liabilities are nonrecourse liabilities under Section 704 – and Section 752. Exculpatory liabilities are nonrecourse liabilities under Section 704 – and Section 752. We seem to be making progress.

That, however, does not prove that exculpatory liabilities produce minimum gain or nonrecourse deductions.

\footnote{Preamble to Treasury Decision 8385, 56 Fed. Register 66978-66995 (December 27, 1991).}

\footnote{Treas. Reg. § 1.752-1(a)(2).}

\footnote{Treas. Reg. § 1.704-2(b)(3).}
At the heart of the definition of “exculpatory liabilities” is “a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability).” We know that these liabilities are not “exculpatory liabilities”:

- Liabilities where a partner or a related party bears the economic risk of loss, subject to the exception for de minimis partners.
- Liabilities where a partner or a related party is the guarantor.
- Liabilities where a partner or a related party is the lender.
- Liabilities that are secured by any specific property.
- Liabilities that are not recourse to the partnership as an entity.
- Liabilities of a partnership where any partner has an unlimited deficit restoration obligation.
- Liabilities of a general partnership.
- Liabilities of a partnership where any partner has a deficit restoration obligation to the extent that the partner bears of the economic risk of loss of the liabilities under the limited deficit restoration obligation.

---

417 Query: why is it important that exculpatory liabilities be unsecured? Is lack of security critical to the tax analysis? Why?

418 Treas. Reg. § 1.752-2(d) (“(d) De minimis exceptions. (1) Partner as lender. The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). (2) Partner as guarantor. The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

It is not clear whether exculpatory liabilities must produce minimum gain – or even can produce minimum gain.

An exculpatory liability, according to Treasury Decision 8385, must be not secured by any specific property and must be recourse to the partnership as an entity. This apparently requires that the liability be full recourse to all partnership assets. A liability isolated in a special purpose LLC that is a subsidiary of a partnership might not qualify as an exculpatory liability because the lender usually is limited to recourse against the assets of the special purpose LLC. The lender cannot reach partnership assets outside of the special purpose LLC in the event of a default on the debt and a deficiency.

A liability that is secured apparently cannot be an exculpatory liability (by definition of “exculpatory liability”) under Treasury Decision 8385. A liability that is secured apparently cannot be an exculpatory liability even though the lender has unlimited recourse to partnership assets and the partners have no liability on the debt. Whether these liabilities should be treated any differently from exculpatory liabilities is a matter that we could debate.

An exculpatory liability apparently must be “explicitly not recourse to any partner.” This may mean more than that the liability is nonrecourse to any partner.


420 Query: what is the result is the partnership holds all of its assets through a subsidiary single member LLC and the lender has no recourse against the partnership nor its partners? What is the result if the partnership holds all of its material assets through a subsidiary single member LLC and the lender has no recourse against the partnership nor its partners? What is the result if the partnership merely holds substantial assets through a subsidiary single member LLC and the lender has no recourse against the partnership nor its partners?

421 “Secured” presumably includes a situation in which specific property is pledged as security for the liability. We could debate the extent to which the liability is “secured” if the amount of the liability exceeds the fair market value of the collateral. “Secured” may include a situation in which a special purpose LLC bears the economic risk of loss of the liability but there is no pledge of the assets of the special purpose LLC. The case can be made that an obligation is “secured” by assets even though there is no pledge. No authority yet addresses whether “secured” requires that the security interest be perfected. A reasonable case can be made that perfection is not required. Partnership taxation is vastly complicated when authorities disagree over what such basic terms as “secured” mean.

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The liability must be “explicitly nonrecourse.” The language of the Preamble to Treasury Decision 8385 suggests that perhaps the loan documents for the exculpatory liability must specifically say that the loan is nonrecourse to any partner. This matter is not unambiguously clear.

A liability might be guaranteed in part by a partner. The guaranteed portion of the liability would not constitute an exculpatory liability. The excess portion of the liability above the guaranteed amount perhaps still might constitute an exculpatory liability. The status of a liability guaranteed by a partner but where the partner is treated as not bearing the economic risk of loss of the liability under the de minimis partner rule is unclear.

A liability may be secured by a pledge of partner property. The pledge of security usually should result in a partner having liability – or, at least, having the economic risk of loss of the liability. The liability is unlikely to qualify as an exculpatory liability on account of the pledge – at least to the extent of that the liability is fully secured by the pledge of the partner’s property. The liability might still be an exculpatory liability to the extent of the amount of the liability

---

423 Query: Precisely what does “explicitly nonrecourse” mean? Why is just being nonrecourse not good enough? Why is “explicitly nonrecourse” required? Is “explicitly nonrecourse” merely linguistic puffing?


425 Treas. Reg. § 1.752-2(d) (“(d) De minimis exceptions. (1) Partner as lender. The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). (2) Partner as guarantor. The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.”).

426 Note that risk of loss might be transferred to another partner under an indemnification agreement.
over the fair market value of the security. The liability therefore could fluctuate in characterization as an exculpatory liability with daily changes in the value of the partner-pledged collateral.

b. Do Exculpatory Liabilities Produce Minimum Gain?

Whether an exculpatory liability can produce minimum gain and whether an exculpatory liability must produce minimum gain are matters that must be left to the future to resolve. Authority is not clear. “Minimum gain” is defined in the Nonrecourse Deduction Regulations:

(2) Definitions of and allocations pursuant to a minimum gain chargeback. To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (“partnership minimum gain”). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. . . . 427

Increases in minimum gain (which generate nonrecourse deductions) apparently depend on liabilities “encumbering” property. This may refer to the pledge of collateral as security for liabilities.428 Such a view is consistent with a

428 See, e.g., Treas. Reg. § 1.704-2(b)(2) (“. . . To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (“partnership minimum gain”). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. . . . If property encumbered by a nonrecourse liability is reflected on the partnership’s books at a value that differs from its adjusted tax basis, paragraph (d)(3) of this section provides that minimum gain is determined with reference to the property’s book basis. . . .” Emphasis added.); Treas. Reg. § 1.704-2(d) (“. . . The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability (footnote continued on the next page)
view under Section 1001 that to be “nonrecourse” under Section 1001 liabilities must be secured by pledged collateral and liability must be limited to that pledged collateral. The word “encumber” appears at various points under the Nonrecourse Deduction Regulations. Each use is consistent with the view that liabilities must be secured by pledged collateral “encumbered” by the liabilities, but the Nonrecourse Deduction Regulations also are consistent with the view that liabilities “encumber” assets if a creditor could reach those assets on a default on the

for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. . . . (2) Property subject to more than one liability. (i) In general. If property is subject to more than one liability, only the portion of the property’s adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(i) of this section is used to compute minimum gain with respect to that liability. (ii) Allocating liabilities. If property is subject to two or more liabilities of equal priority, the property’s adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. . . . (3) . . . If partnership property subject to one or more nonrecourse liabilities is, under section 1.704-1(b)(2)(iv)(d), (f), or (r), reflected on the partnership’s books at a value that differs from its adjusted tax basis, the determinations under this section are made with reference to the property’s book value. . . . (4) . . . If the partners’ capital accounts are increased pursuant to section 1.704-1(b)(2)(iv)(d), (f), or (r) to reflect a revaluation of partnership property subject to a nonrecourse liability, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by: . . .” Emphasis added.). Treas. Reg. § 1.704-2(h)(1) (“. . . If during its taxable year a partnership makes a distribution to the partners allocable to the proceeds of a nonrecourse liability, the distribution is allocable to an increase in partnership minimum gain among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain to the extent the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property’s adjusted tax basis. . . .” Emphasis added.). Treas. Reg. § 1.704-2(k)(3) (“. . . The increase in the upper-tier partnership’s minimum gain (under paragraph (k)(1) of this section) attributable to the receipt of those distributions is, for purposes of paragraph (h) of this section, treated as an increase in the upper-tier partnership’s minimum gain arising from encumbering property of the upper-tier partnership with a nonrecourse liability of the upper-tier partnership.” Emphasis added.). 429 See note 428.

429 See note 428.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

liabilities. Nevertheless, “encumber” may be a sufficiently flexible term that “encumber” means that the asset is burdened by a potential claim by the creditor if the debtor defaults on the liability.

The definition of “partnership minimum gain” states that “[t]o the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (‘partnership minimum gain’).”

This proposition is true only if the liability is a nonrecourse liability under Section 1001. A liability similarly should generate minimum gain only if the

430 Treas. Reg. § 1.1001-2(a)(1), (4) (“(a) Inclusion in amount realized (1) In general. Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. . . . (4) Special rules. For purposes of this section – (i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability; (ii) The sale or other disposition of property that secures a re-

(footnote continued on the next page)
liability “encumbers: property.” This may suggest a pledge of the property, although that is not be completely clear.

A disposition of a property subject to a recourse liability will generate gain limited by the excess of the fair market value of the property over the adjusted tax basis of the property. An excusable liability while nonrecourse under Section 704 and Section 752, is not clearly nonrecourse debt under Section 1001, as an excusable liability is unsecured and full recourse to all partnership assets. The amount of the “book” gain will be zero if we apply the value equals basis presumption. The remaining debt over “book” value potentially would create cancellation of indebtedness income rather than gain.

course liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability).

432 Treas. Reg. § 1.704-2(b)(2) (“To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (“partnership minimum gain”).’ Emphasis added.).

433 See note 431.

434 See, e.g., Commissioner v. Tufts, 335 U.S. 300, 304 (1983) (“The only difference between [a nonrecourse] mortgage and one on which the borrower is personally liable is that the [nonrecourse] mortgagee’s remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. If the FMV of the property falls below the amount of the outstanding obligation, the mortgagee’s ability to protect its interests is impaired, for the mortgagor is free to abandon the property and be relieved of his obligation.”).

435 Treas. Reg. § 1.704-1(b)(2)(ii)(c) (“. . . For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. . . .”).
We also should recall the safe harbor for allocating nonrecourse deductions. Among other things, the safe harbor for allocation of nonrecourse deductions requires:

(2) Beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership, partnership agreement provides for allocations of nonrecourse deductions 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; . . .  

This language suggests that nonrecourse liabilities are “secured.” The idea of being “secured” typically connotes that property is pledged as security for the nonrecourse liabilities, not that the nonrecourse liabilities are “not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner.” 437 Exculpatory liabilities, by definition, are not secured by a pledge of property as collateral for the exculpatory liabilities – not, at least, as the term “secured” is typically used in normal commercial practice.

The Nonrecourse Deduction Regulations also address property that is “subject to” more than one liability. 438 This portion of the Nonrecourse Deduction Regulations may imply that some property must be “subject to” each nonrecourse debt. This language generally means that the property that is “subject to” a nonrecourse debt has been pledged as security for the nonrecourse debt. An “exculpatory liability,” however, is unsecured by definition. This provides further inferential evidence that exculpatory liabilities are not nonrecourse debt. Exculpatory liabilities are not “secured,” at least not in the most common use of the term “secured,” which requires a pledge.

437 Preamble to Treasury Decision 8385.
438 Treas. Reg. § 1.465-27(b)(1). Treas. Reg. § 1.704-2(e)(2) (“(2) Property subject to more than one liability. (i) In general. If property is subject to more than one liability, only the portion of the property’s adjusted tax basis that is allocated to a nonrecourse liability under paragraph (d)(2)(ii) of this section is used to compute minimum gain with respect to that liability. (ii) Allocating liabilities. If property is subject to two or more liabilities of equal priority, the property’s adjusted tax basis is allocated among the liabilities in proportion to their outstanding balances. If property is subject to two or more liabilities of unequal priority, the adjusted tax basis is allocated first to the liability of the highest priority to the extent of its outstanding balance and then to each liability in descending order of priority to the extent of its outstanding balance, until fully allocated. . . .”
This reasoning suggests that only liabilities that are nonrecourse liabilities under Section 1001 will generate minimum gain, although this proposition is controversial and uncertain. Only liabilities that are nonrecourse liabilities under Section 1001 produce nonrecourse deductions, by extension of reasoning. Exculpatory liabilities do not produce minimum gain or nonrecourse deductions if exculpatory liabilities are not nonrecourse liabilities under Section 1001.

_Great Plains Gasification Associates v. Commissioner_439 suggests the possibility of applying a Section 752 analysis to partnership debt for purposes of determining whether a liability is nonrecourse for purposes of Section 1001. Whether this is what _Great Plains Gasification Associates_ holds and, if so, whether this holding is correct, are matters that have not yet been resolved.

Material doubt exists that debt that is full recourse to the partnership and that is unsecured can be classified as “nonrecourse debt” under Section 1001. This uncertainty is based on these observations:

- Nonrecourse deductions depend on the annual increase in minimum gain.440
- Nonrecourse deductions appear to depend on generating a minimum amount of gain under Section 1001 on a foreclosure.441
- This may depend on debt being classified as “nonrecourse debt” under Section 1001.
- Debt may have to be secured by a pledge of property in order to be classified as “nonrecourse debt” under Section 1001.

---

440 Treas. Reg. § 1.704-2(c) (“(c) Amount of nonrecourse deductions. The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section) . . . However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a _pro rata_ portion of other partnership losses, deductions, and section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over . . .”).
441 This matter has not been unambiguously established.
Debt that is full recourse to all assets of a partnership may not qualify as “nonrecourse debt” under Section 1001.

Debt that is not secured may not qualify as “nonrecourse debt” under Section 1001.

Nonrecourse debt apparently must “encumber” property in order to generate nonrecourse deductions. “Encumber” may require a pledge of the property encumbered as collateral for the debt.\footnote{442}

Exculpatory liabilities, by definition, are unsecured.

Exculpatory liabilities, by definition, are full recourse to all partnership assets.

Of course, we also can ask, if Treasury and the Internal Revenue Service intended that nonrecourse debt be limited to debt that is nonrecourse for purposes of Section 1001, why did the Nonrecourse Deduction Regulations not say so? The failure of the Nonrecourse Deduction Regulations to define “nonrecourse” debts in terms of Section 1001 but rather to rely on a definition under Section 752 perhaps suggests that Treasury did not intend to limit nonrecourse deductions to debt that is nonrecourse under Section 1001.

All of this is speculative and not at all conclusive. The law in this area is far from resolved. The matter is not decisively resolved.

Substantial doubt exists that exculpatory liabilities generate minimum gain or generate nonrecourse deductions.\footnote{443} Doubt about whether exculpatory deductions are merely a special case of nonrecourse deductions and whether exculpatory deductions produce minimum gain significantly complicates drafting allocations for exculpatory deductions.

c. **Calculating Exculpatory Deductions if Exculpatory Liabilities Produce Nonrecourse Deductions.**

Either a court of the Internal Revenue Service may conclude that exculpatory liabilities produce minimum gain and that exculpatory deductions are merely a subset of nonrecourse deductions. If so, exculpatory deductions should be controlled by the nonrecourse deduction rules of the Nonrecourse Deduction Regulations.

\footnote{442} See note 440.

\footnote{443} Nonrecourse deductions may depend on a foreclosure producing gain equal to the excess of fair market value over adjusted tax basis (or “book” value, as the case may be). The foreclosure of a recourse liability can produce a combination of gain and cancellation of indebtedness income.
Based on the assumption that exculpatory deductions are nonrecourse deductions, we need to be able to determine the annual increase in minimum gain attributable to exculpatory deductions. The Nonrecourse Deduction Regulations are not entirely helpful. Nevertheless, it seems that exculpatory liabilities should be treated as if they encumber all partnership assets, including cash, with a lowest priority lien. Minimum gain attributable to the exculpatory liability could be determined by the excess of the exculpatory liabilities over the tax basis of all partnership assets. This approach might treat potential cancellation of indebtedness income associated with the exculpatory liability as a component of minimum gain.

d. Calculating Exculpatory Deductions If Exculpatory Liabilities Do Not Produce Minimum Gain.

A court or the Internal Revenue Service might conclude that exculpatory liabilities do not produce minimum gain and that exculpatory deductions are not nonrecourse deductions. This would force us to produce some mechanism to determine what deductions are exculpatory deductions and also to determine how income later offsets the earlier exculpatory deductions. This suggests a possible analysis of exculpatory deductions if exculpatory liabilities do not produce minimum gain.

Assume that an LLC that was capitalized by capital contributions. The LLC also has exculpatory liabilities. The LLC has no nonrecourse liabilities or recourse. None of the members of the LLC has a capital account deficit restoration obligation.

One of the members will bear the economic risk of loss of the deductions while any member has a positive capital account. The LLC should not have exculpatory deductions while a partner bears the economic risk of loss of the deductions. By definition, no partner bears the economic risk of exculpatory deductions. The partners bear the economic risk of loss of partnership deductions while the partners have positive capital accounts. Once the LLC has had sufficient deductions (or a combination of deductions and distributions) to reduce each partner’s capital account to zero, no partner bears the economic risk of loss of LLC deductions. Deductions are allocable to exculpatory liabilities after this point. These deductions are exculpatory deductions. This analysis is not clearly indicated in the Nonrecourse Deductions Regulations, but it is a plausible explanation of exculpatory deductions.

When all partners have deficit capital accounts, the first income will not result in an economic benefit to the partners. The cash, if any, associated with the income would be used to discharge the exculpatory liabilities if the LLC were to liquidate. The income alternatively might be cancellation of indebtedness income associated with the exculpatory liabilities. This income should be allocated to the
partners who received the corresponding exculpatory deductions. We might pre-
sume that this income will be allocated to partners in accordance with the ratio of
their past exculpatory deductions until these allocations have fully charged back
prior allocations of exculpatory deductions. The income otherwise could be allo-
cated in accordance with the ratio of negative capital accounts (adjusted by in-
creasing capital accounts by partners’ shares of minimum gain and partner mini-
mum gain).

We can add nonrecourse liabilities to the model. In that case, the LLC
starts having exculpatory deductions when the partner capital accounts in the ag-
gregate have a negative amount the absolute value of which is greater than the
amount of minimum gain. If the amount of minimum gain is X, then the LLC will
have exculpatory deductions when the LLC has further deductions (other than
nonrecourse deductions) that cause the partner capital accounts to be less than −X.
The minimum gain chargeback will operate in its normal manner.

The analysis of the LLC with minimum gain is easily expanded by exten-
sion of reasoning to partner nonrecourse deductions.

e. Identifying Exculpatory Deductions.

There are at least two elements in drafting for exculpatory deductions. The
first is to identify exculpatory deductions. The second is to decide how to draft the
allocation of exculpatory deductions. A third possible element is to provide for
chargeback allocations if allocations of exculpatory deductions are economically
reversed by partnership profits.

This discussion will assume that exculpatory deductions do not produce
minimum gain. This discussion will assume that exculpatory deductions are not
nonrecourse deductions.

Identifying exculpatory deductions requires an economic analysis of part-
nership operations to determine when deductions are not attributable to capital
contributions, retained earnings, recourse debt, nonrecourse debt, or partner non-
recourse debt.

The partnership first should identify nonrecourse deductions and partner
nonrecourse reductions. These classes of deductions are determined by formula
under the Nonrecourse Deduction Regulations.

The partnership next should identify recourse deductions. Recourse dedu-
cions are deductions where a partner or related person bears the economic risk of
loss. The partnership should have recourse deductions as long as the partnership is
able to apply the alternate test for economic effect.\(^444\) The partnership should have

recourse deductions as long as the partners have nonnegative adjusted capital accounts, computed by adding back minimum gain and partner minimum gain.

The partnership, at some point, will reach the point at which no partner has a positive adjusted capital account (computed by adding back minimum gain and partner minimum gain). The partnership may have stopped producing nonrecourse or partner nonrecourse deductions. The partnership can have (but does not necessarily have) exculpatory deductions at this point. Exculpatory deductions should be common.

Partnership deductions, at this point, typically are economically funded by debt that is nonrecourse to the partners and that is recourse to the partnership and its assets. Unsecured debt of a limited liability company (nonrecourse to the members, but full recourse to the limited liability company) typically should produce exculpatory deductions at some point during the life of the limited liability – after all, partners have nonpositive adjusted capital accounts (computed by adding back minimum gain and partner minimum gain).

We might set aside, for the moment, the problem that debt might be recourse to the partnership, but secured by some partnership assets. Debt that is nonrecourse to the partners, secured by some partnership assets, and full recourse to the partnership, might not produce nonrecourse deductions. This debt also does not produce exculpatory deductions. There is not adequate formal guidance concerning the deductions that this debt produces.

These appear to be the general conditions for the production of exculpatory deductions:

- No partner has a positive adjusted capital account (capital account increased by minimum gain and partner minimum gain).
- The partnership has exculpatory debt – debt that is:
  - Unsecured,
  - Recourse to all partnership assets, and
  - Nonrecourse to the partners.

---

445 Deductions at this point could be funded by recourse debt, by debt that is secured but nonrecourse to the partners, or debt that is unsecured but nonrecourse to some but not all partnership assets. The partnership also could have nonrecourse deductions or partner nonrecourse deductions.
• The partnership has deductions beyond nonrecourse deductions, beyond partner nonrecourse deductions, and beyond recourse deductions.

f. Allocating Exculpatory Liabilities.

The allocation of exculpatory liabilities for purposes of Section 752 perhaps will provide guidance concerning how the exculpatory deductions should be allocated under partners’ interests in the partnership if exculpatory deductions are not nonrecourse deductions. Exculpatory liabilities are merely nonrecourse liabilities for purposes of Section 752. Exculpatory liabilities are allocated under the normal nonrecourse liabilities allocation rules:

(a) In general. A partner’s share of the nonrecourse liabilities of a partnership equals the sum of paragraphs (a)(1) through (a)(3) of this section as follows–

(1) The partner’s share of partnership minimum gain determined in accordance with the rules of section 704(b) and the regulations thereunder;

(2) The amount of any taxable gain that would be allocated to the partner under section 704(c) (or in the same manner as section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

(3) The partner’s share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner’s share of partnership profits. The partner’s interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under section 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in section 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of section 1.707-5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph.
Whether exculpatory liabilities are allocated under the (a)(1) tier will depend on whether exculpatory liabilities generate minimum gain. This is a matter that is uncertain.

Whether exculpatory liabilities are allocated under the (a)(2) tier will depend on whether there is a “book”-tax disparity and whether partnership property is treated as “subject to” the exculpatory liabilities. This is a matter that is far from certain.

The (a)(3) tier may be important in allocating exculpatory liabilities. The most important rule for allocating exculpatory liabilities may allocate exculpatory liabilities in accordance with the partner’s share of partnership profits. Determining the partner’s interest in partnership profits is simple enough when the partnership economics are based completely on a simple percentage allocation scheme. Special allocations under the (a)(3) tier depend on “the interests so specified are reasonably consistent with allocations (that have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain.” Many partnership agreements, likely including those partnership agreements that use target allocations, have allocations that do not have substantial economic effect. This require a more holistic approach to determining profits in the (a)(3) tier. A fallback when allocations do not have substantial economic effect is “by taking into account all facts and circumstances relating to the economic arrangement of the partners.” That often can be a difficult inquiry. Also, “excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated.” That may be difficult to determine with exculpatory liabilities.

The partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Section 704(c) property or property for which reverse Section 704(c) allocations are applicable where the property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in tier (a)(2) with respect to the property. This rule can be useful if property is treated as subject to the exculpatory liability. This matter is in doubt. Exculpatory liabilities are unsecured. “Subject to” may require that property be pledged as security for the liability.

---

446 Treas. Reg. § 1.752-2(a).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING Partnership AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in tier (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.

g. Allocating Exculpatory Deductions If Exculpatory Deductions Produce Minimum Gain.

We need to decide how to allocate exculpatory deductions once we have identified them. We know from the preamble to Treasury Decision 8385 that:

Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).

The principles of the basic test of economic effect, the alternate test for economic effect, and economic effect equivalence do not seem to apply well to exculpatory deductions. These three tests base allocations of the deductions on who bears the economic risk of loss. No partner bears the economic risk of loss of exculpatory deductions.

Allocations of exculpatory deductions are similar to the allocation of nonrecourse deductions in the sense that no partner bears the economic risk of loss of the allocation.

Allocations of exculpatory deductions simply follow the allocation rules for nonrecourse deductions if exculpatory deductions are merely a special class of nonrecourse deductions. The Nonrecourse Deduction Regulations respect allocations of nonrecourse deductions if these requirements are satisfied:

- The partnership satisfies the capital account maintenance and capital account liquidation requirements and the partnership satisfies either the deficit capital account restoration obligation test of the basic test of economic effect or the alternate test for economic effect. The partnership must satisfy this requirement throughout the full term of the partnership.
- The partnership satisfies the reasonable consistency requirement: the partnership agreement provides for allocations of nonrecourse deductions in a manner that is reasonably consistent with alloc-

---

tions that have substantial economic effect of some other significant partnership item attributable to the property securing the non-recourse liabilities. The partnership must satisfy this requirement beginning in the first taxable year of the partnership in which there are nonrecourse deductions and thereafter throughout the full term of the partnership.

- The partnership agreement contains a provision that complies with the minimum gain chargeback requirement. The partnership must satisfy this requirement beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership.

- All other material allocations and capital account adjustments under the partnership agreement are recognized under the Allocation Regulations.

Exculpatory deductions might be nonrecourse deductions. If so, exculpatory deductions are simply allocated under the normal nonrecourse deduction rules. Exculpatory deductions normally would be lumped together with other nonrecourse deductions and allocated with those other nonrecourse deductions. The partnership agreement also should contain a minimum gain chargeback.

h. Allocating Exculpatory Deductions If Exculpatory Deductions Are Not Nonrecourse Deductions And Do Not Produce Minimum Gain.

The matter is more complicated if exculpatory deductions are not nonrecourse deductions and exculpatory deductions do not generate minimum gain. The situation is decidedly untidy. Allocating exculpatory deductions is speculative and uncertain if exculpatory deductions are not nonrecourse deductions and do not produce minimum gain.

Recourse deductions are allocated to the partner who bears the economic risk of loss of the capital contributions or liabilities that funded the recourse deductions. No partner, however, bears the economic risk of loss of exculpatory deductions. As discussed above, there is a reasonable position that exculpatory deductions are incurred after all partners have zero of negative capital accounts.

Allocations of exculpatory deductions intrinsically do not have economic effect as exculpatory deductions merely increase capital accounts for which the partners do not have personal liability.

If exculpatory deductions are not nonrecourse deductions, then we apparently need to look to partners’ interests in the partnership for guidance concerning
allocating exculpatory deductions. The rules of partners’ interests in the partnership unfortunately offer weak guidance.

Partners’ interests in the partnership reflects “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.” This determination “takes[es] into account all facts and circumstances relating to the economic arrangement of the partners.” The inquiry considers these factors, among others:

- The partners’ relative contributions to the partnership,
- The interests of the partners in economic profits and losses (if different than that in taxable income or loss),
- The interests of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation.

These factors unfortunately provide limited guidance concerning determining how to allocate exculpatory deductions in all but the simplest situation. The simplest situation is a straight percentage partnership. Then, exculpatory deductions presumably are allocated in accordance with those straight percentages.

The practical answer is that we do not know how partners’ interests in the partnership applies to exculpatory deductions, if partners’ interests in the partnership controls. We are not even entirely sure which deductions are exculpatory deductions. The discussion above has set forth the case that deductions (that are not nonrecourse deductions or partner nonrecourse deductions) are exculpatory deduction after partners’ capital accounts are reduced to zero. Partners’ interests in the partnership does not provide us with clear guidance how to allocate these exculpatory deductions.

While the scheme for allocating exculpatory deductions is not clear, the scheme for allocating exculpatory liabilities is clear. Exculpatory liabilities are allocated under the regulations governing nonrecourse liabilities. As a theory

---

450 Id.
452 More technically, this should be reduced to zero where no partner has a capital account capital account deficit restoration obligation or a similar financial obligation that is a deemed capital account deficit restoration obligation.
(completely untested), it seems plausible that exculpatory deductions should be allocated to the same partners who are allocated exculpatory liabilities. Exculpatory deductions could be allocated among these partners in accordance with the ratio in which exculpatory liabilities are allocated to these partners. This might be a sensible allocation of exculpatory deductions. It is the exculpatory liabilities that produce the exculpatory deductions.

Income later should be allocated to partners who received exculpatory deductions. This allocation might be made to partners in accordance with past allocations of exculpatory deductions until all past allocations of exculpatory deductions have been fully charged back. This allocation presumably should have priority after the minimum gain chargeback and partner minimum gain chargeback. The chargeback of exculpatory deductions also might follow allocations under the qualified income offset.

The income chargeback for exculpatory deductions alternatively might merely chargeback negative capital accounts. For this purpose, negative capital accounts should be increased by shares of minimum gain and partner minimum gain. There presumably also should be an increase to capital accounts for unconditionally obligated contribution obligations.

All of this is a matter with a high degree of speculation. We do not clearly know what deductions are exculpatory deductions. We do not know whether exculpatory deductions are allocated under the nonrecourse deduction rules. Legitimate arguments favor both sides of this question.

The allocation rules should be straightforward if exculpatory deductions are nonrecourse deductions that produce minimum gain. The allocation rules are considerably more uncertain if exculpatory deductions are not nonrecourse deductions. In the absence of clarifying Treasury Regulations, the partnership should not be overly confident of its ability to anticipate how final Treasury Regulations addressing exculpatory deductions will resolve the allocation issues.

Perhaps the most reliable manner in which to address allocations of exculpatory deductions in an absence of clear authority is merely to provide that exculpatory deductions should be allocated in accordance with partners’ interests in the partnership to the extent that exculpatory deductions are not nonrecourse deductions.


The purposes provision defines the scope of the business of the partnership. The purposes provision can define the outer bound of partnership activities. Simplicio pays little attention to the purposes provision.
The purposes provision provides protection to both passive investors and the manager. The investors contracted to enter a specific type of investment. The purposes provision controls what the partnership does and controls that the partnership is limited to the investment that the investors thought that they were getting into. The purposes provision establishes theme of the partnership. The purposes provision aids the manager by approving specific investments. The purposes provision should disapprove other investments that are outside of the purposes of the partnership.

An example of problems is a purposes provision that limits the partnership to a specific investment. The partnership agreement may authorize Section 1031 exchanges. The problem is that any replacement property may not be permitted under the purposes provision. The purposes provision may prohibit the partnership from undertaking Section 1031 exchanges even though the partnership otherwise approves exchanges.

37. Carelessly Draft Terms for Cash Capital Contributions.

Partnership and LLC agreement provisions concerning contributions of cash and property are often off-hand and badly developed. These provisions often create later difficulty when the partnership seeks to enforce these provisions.453

Simplicio often compromises provisions concerning additional capital contributions. The partnership agreement may adjust partnership interests if some but not all partners make discretionary capital contributions. The partnership agreement may adjust partnership interests if a partner defaults on his obligation to make capital contributions. The adjustments can include changes in basic partnership percentages, adjustments in capital accounts, shifts in capital accounts, adjustments in unrecovered investment, shifts in unrecovered investment, and other changes in partnership economics.454

Salviati thinks through and tests with numerical models all of the economic provisions that can be affected when one partner defaults on a capital contribution or fails to make a discretionary capital contribution. Salviati has the partner-


454 Give special consideration to these adjustment provisions when service partnership interests are affected.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ship accountants model all of these provisions so that he is assured that all economic provisions will work satisfactorily if there is an adjustment on a default.

Simplicio is more economical and avoids wasting his time on these distractions.

Salviati considers and models the consequences of provisions that adjust interests where the partnership includes partners who received their partnership interests in consideration for the performance of services.\footnote{The percentage interests of most partners may be based on their unrecovered capital contributions. The percentage interest of a service partner usually is larger than what his percentage interest would be if that interest were based on his unrecovered capital contribution. Adjustment provisions that are based on unrecovered capital contributions often fail to give the service partner proper consideration for the value of his services.}

Simplicio trusts in his form, his insurance, and his protective angel.

An important issue in many partnerships is whether the managers will acquire their equity interests in the venture for cash pro rata with other investors, or whether the managers may simply waive future management fees in lieu of making capital contributions.

Salviati addresses these issues:

- In what form does the partnership agreement require capital contributions to be made (personal check, cashier’s check, certified check, certified cashier’s check, federal funds check, wire transfer, \textit{etc.})?
- When are amounts deemed received by the partnership?
- How much time should be allowed for a partner to muster cash after notice to make a capital contribution?
- How will the partnership survive financially if a partner defaults in making a capital contribution?
- What are the consequences of a default in a partner’s obligation to make an additional capital contribution?\footnote{The draftsman should be careful to deal with default in making initial capital contributions. Consider whether a new partner should be admitted to the partnership if he defaults in his initial capital contribution.}
- Can the other partners withdraw capital contributions on a default by the defaulting partner?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• Consequences of service partnership interests on dilution provisions.
• Consequences of capital contributions and dilution provisions on capital accounts.
• Consequences of capital contributions and dilution provisions on percentage interests.
• Consequences of capital contributions and dilution provisions on tier shifts.
• Consequences of capital contributions and dilution provisions on preferred returns.
• Consequences of capital contributions and dilution provisions on internal rates of return.
• How does the partnership handle cost overruns?
• Enforceability of dilution provisions.\(^{457}\)
• Tax consequences of dilution.
• All of the mechanics of a call for additional capital.
• The purposes that can be used as the basis for a call for additional capital.
• Whether the partnership must seek to borrow funds (and upon what terms the partnership must seek to borrow) prior to making a call for capital.
• The distinction between capital contributions and partner loans.
• Who should have the obligation to fund cost overruns?
• What are the effects of these contributions?
• Conditions to the call.
• The vote necessary to approve a call for additional capital contributions.
• Who makes the call?

\(^{457}\) A partner might assert that a particular dilution provision acts as a liquidated damages provision. That provision may not meet the legal requirements for a liquidated damages provision. This question should be considered on a state-by-state basis.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- A cap on the amount that can be called. Lifetime cap? Cap on each individual call?
- A minimum time period between calls.
- Should all partners be subject to the call?
- How does a partner with minimal funds mitigate the threat of a future call?
- Can the call be limited so that it is not used for oppressive purposes?
- In what ratio are additional capital contributions made?
- The form of notice of the call.
- The timing for contributions to be made after a call.
- What form of transmission of capital contributions is required?
- Whether additional contributions are mandatory.
- What happens if a partner does not make his required additional capital contribution? \(^{458}\)
  - What is the “equitable” way to adjust partnership interest? How should partnership interests be adjusted?
  - What is the effect if a partner makes additional capital contributions early?
  - What is the effect if a partner makes additional capital contributions late?

---

\(^{458}\) Partners often desire that the partnership agreement contain harsh remedies if a partner defaults on a cash capital contribution. Some partners would like to strip the defaulting partner naked, slather him in honey, and bury him up to the neck in a mound of fire ants. Other partners wish to fit the defaulting partner with concrete overshoes and drop him into a deep body of water. Both of these remedies are discouraged. An important consideration is whether state courts or bankruptcy courts will enforce a default remedy. The default remedy may do the partnership little good if a court will not enforce the remedy. The partnership then will be left to its own in implementing remedies such as fire ants or concrete overshoes. Each of these alternative remedies is accompanied by its own disadvantages.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- What is the effect if a partner does not make required additional capital contributions at all?
- Whether nondefaulting partners can make the additional capital contribution of a defaulting partner. What is the result?
- If additional contributions by nondefaulting partners treated as partner loans, what are the loan terms?
- Consider the possibility that the project is in trouble if it becomes necessary to make additional capital calls. Should this call for special provisions to address the troubled project?
- Consider the special economic situations of the various partners, some of whom may have the ready availability to satisfy a call and others who may not have this ability.
- Consider the possibility of changed economic circumstances of the partners.
- Examples of the operation of dilution provisions.
- Where appropriate, Salviati provides for a defined investment period that only can be extended by a defined vote of passive investors in the partnership.
- Where appropriate, Salviati provides for key man provisions that permit passive investors the ability to terminate the investment period or to appoint a new manager.459

38. Carelessly Draft Terms for In-Kind Contributions of Property.

In-kind contributions of property are more complicated than cash contributions are. In-kind contributions of property involve practically all of the considerations of cash capital contributions, plus the special considerations of property transfers. The prevailing standard of practice among partnership agreement draftsmen is a low standard – sometimes a very low standard. The needs of a partnership agreement for property contributions are similar to the issues discussed in a purchase and sale agreement. Partnership agreements, however, typi-

459 Provisions of this type may be based on the ability of a key person or a defined collection of key persons involved in the management company devoting a defined about of their professional time to partnership management.
cally have much less extensive contribution provisions than a purchase and sale agreement’s sale provisions. This betrays either a trust in contributing partners or a naïveté concerning contributions.

Simplicio makes these common errors with respect to partnership agreement provisions for property contributed by a partner:

- Failure adequately to describe the transferred property and ancillary property.460

---

460 This might include, without prejudice to generality, legal description of the tract of land, description of transferred or reserved rights, interests of contributing partner in and to any land lying in the beds of any streets, roads or avenues, open or proposed, public or private, and all easements, rights, licenses, privileges, rights-of-way, strips and gores, mineral rights, air development rights, rights of ingress and egress, hereditaments and other real property rights, interests appurtenant to the foregoing rights, interest of contributing partner in any unpaid award for the taking by eminent domain of any part of the land or for damage to the land by reason of a change of grade of any street, the buildings, structures, improvements, fixtures and facilities in, on, under or over the real property, interest in the foundations and footings, elevators, plumbing, air conditioning, heating, ventilating, mechanical, electrical and utility systems, signs and light fixtures, doors, windows, fences, parking lots, parking structures, walks and walkways and other type of physical improvement located at, on or affixed to the real property and, any other improvements, contributing partner’s right, title and interest in all leases of the real property, all prepaid rents and deposits, security or otherwise, paid to and held by contributing partner pursuant to the leases, copyrights, trade names, trademarks and other intellectual property rights owned by the contributing partner and used in connection with the property, all of contributing partner’s right, title and interest in the equipment, machinery, furniture, furnishings, supplies, alarms, security systems, back-up power generation systems, business files and records of contributing partner (including, without prejudice to generality, copies of all books, records, and files maintained by contributing partner related to the property (other than copies of all information or materials required to be kept confidential by any contract or applicable law, tax returns, privileged attorney-client communications or attorney-work product), copies of all existing leases and pending tenant leases and other tenancy agreements, all tenant files (including, without prejudice to generality, background and financial searches and copies of all tenant financial statements), a schedule of leasing commissions and tenant improvements on a space by space basis, a copy of the current standard lease form, a current rent roll of the property, construction contracts, architects’ drawings and renderings, blueprints and as-built plans for the property, operating statements (including tax (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure to include adequate provisions regarding title commitment and survey.\(^{461}\)
- Failure to include adequate provisions regarding delivery and requirements of the title policy.\(^{462}\)
- Failure to include adequate provisions regarding investigation of the property.\(^{463}\)

and utility bills), budgets, engineering reports, ALTA surveys, architectural drawings, building permits and inspection reports, environmental reports, soils/geologic reports, notices and demands from any governmental agencies, appraisal reports, CC&Rs, existing or pending vendor contracts (including, but not limited to, all maintenance, management, landscaping, security, HVAC and similar contracts), any and all warranties relating to the property and any other relevant documentation affecting the property and current certificates of insurance, insurance policies and insurance history, service files, legal files, complaint files, employee files, business plans, projections, pro formas, spreadsheets, correspondence, leases, contracts, service contracts, and other agreements, and copies of personal property warranties, instruction manuals, and repair manuals) relating to the premises (regardless of the media on which these business files and records are maintained, including maintenance on paper or on electronic media) and other tangible personal property, if any, owned by contributing partner and located in and used in connection with the operation, ownership or management of the real property, specifically excluding any items of personal property owned by tenants at or on the real property and further excluding any items of personal property owned by third parties and leased to contributing partner, the maintenance, service, operating, repair and other contracts relating to the ownership and operation of the premises.

\(^{461}\) This might include timing of delivery of a commitment for title insurance, nature of the policy, provisions regarding survey, legible copies of all documents referred to in the commitment, and provisions regarding approval or disapproval of defects in title. This may include an investigatory period and a cure period. It also should address endorsements.

\(^{462}\) This should address who bears the cost, who is the insurer, form of policy, amount of the policy, what the policy should say, and permitted exceptions. This also should address endorsements and who will bear the cost of endorsements.

\(^{463}\) This might include who has the right to investigate, an investigation period, hours during which investigation is permitted, whether entry onto the property is permitted, notice prior to entry, right to conduct non-destructive or invasive studies (e.g., soil condition, zoning, access, wetlands, environmental, regulatory, title and similar studies). This also might address limitations on investigation and test-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Failure to include adequate provisions regarding assumed contracts. 464
- Failure to include adequate provisions regarding termination during the investigatory period.

ing (such as noninvasive testing). It should be clear what environmental investigation the partnership can undertake (e.g., Phase I environmental site assessment). The agreement should clarify whether the partnership has the right to conduct a perimeter survey and a site and environs reconnaissance, take surface soil and water samples, undertake sampling of building materials, undertake subsurface soil drilling, boring, or excavation, undertake groundwater monitor well installation and sampling, undertake drum sampling, undertake sampling of transformers and capacitors for polychlorinated biphenyls, undertake geophysical testing for buried tanks, drums and other structures, and undertake testing of underground storage tanks. The agreement should clarify whether the partnership has the right to undertake seismographic and other geological testing. It should be clear whether and under what conditions the partnership can contact the contributing partner’s personnel, agents, and those doing business with contributing partner (including lessees). This also might include a provision like this: By entering into this agreement, the partnership acknowledges that the partnership has been given the opportunity to perform its own commercially reasonable independent investigation and evaluation of the property and all other aspects of the transactions contemplated by this agreement, including the partnership’s right to conduct Phase I environmental studies at the partnership’s sole cost and expense, and the partnership agrees that the partnership will be charged with knowledge of all information which is acquired by the partnership as a result of such an investigation and evaluation or which would or should have been acquired by the partnership as a result of a commercially reasonable investigation and evaluation. The partnership specifically acknowledges that the partnership is not relying on contributing partner to indicate the relative importance or materiality of any of the property documents or other information made available to the partnership for review, that the partnership will make its own determination as to the level of scrutiny it applies to the property documents made available to the partnership, and that the partnership will act solely in reliance upon its own investigation and evaluation of such matters.

464 This might include advice from the partnership to the contributing partner as to which service contracts related to the property the partnership will assume upon closing, provision for notifying each of the parties to the assumed contracts of the assignment of the assumed contract from contributing partner to the partnership, and any required consent to the assignment.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure to include adequate provisions regarding partnership repairing damage resulting from the partnership’s investigation of contributed property.
- Failure to include adequate provisions regarding interim operational covenants for operating the property prior to contribution.\textsuperscript{465}

\textsuperscript{465} The covenants might include: (a) contributing partner will (i) operate and maintain the property in accordance with contributing partner’s normal maintenance and management practices utilized in the ordinary course of contributing partner’s business, (ii) not make any alterations or changes to the property, except in the ordinary course of business, and (iii) not remove any of the personal property except if replaced by personal property of equal or greater value and utility; (b) contributing partner will not sell, transfer, convey or encumber, or cause or permit to be sold, transferred, conveyed or encumbered, the property, or any part of the property or interest in the property, or consent to or acquiesce in any alteration or amendment to the zoning classification of the property, or otherwise perform or permit any act or deed which will diminish, encumber or affect contributing partner’s rights in and to the property or prevent it from performing fully its obligations hereunder; (c) contributing partner will not, without the prior written consent of the partnership, enter into any new leases or other occupancy agreements for all or any portion of the property; (d) contributing partner will maintain its present property and comprehensive general liability insurance in force with respect to the property and in such amounts as is maintained by contributing partner on the date of the commitment to transfer; (e) contributing partner will not, without the prior written consent of the partnership, (i) enter into any maintenance, leasing, service, operation, repair or other contract or agreement relating to the use, maintenance or operation of the property, or renew any existing contract unless these are assignable to the partnership and cancelable upon not more than thirty (30) days’ notice without cost or penalty, (ii) modify or terminate any contracts related to the property except by reason of (1) a default thereunder by the provider of the service pursuant to the contracts, or (2) the written request of the partnership, or (iii) modify or terminate any leases of the property except (1) by reason of a default that is not cured during any applicable notice and cure period or (2) with the written consent of the partnership; (f) contributing partner will continue to perform all of its obligations under the contracts related to the property; (g) contributing partner will pay, in the normal course of business, and in any event, prior to closing, all sums due for work, materials or services furnished or otherwise incurred in the ownership and operation of the property up to the closing date; (h) contributing partner will promptly notify the partnership in writing of (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and
Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure to include adequate provisions regarding transferor’s representations and warranties.\(^{466}\)

Any litigation or governmental proceeding to which contributing partner is or becomes a party affecting the property or any part of the property.

\(^{466}\) These warranties and representations are typical of warranties and representations that the contributing partner might make in a contribution agreement: 

(a) Contributing partner has the full right, power and authority to enter into the contribution agreement and to contribute and to convey the property to the partnership as provided herein and to carry out its obligations under this contribution agreement. None of the execution, delivery or performance of the contribution agreement by contributing partner does or will, with or without the giving of notice, passage of time or both (1) violate, conflict with, constitute a default under (A) any material agreement, instrument or other document to which contributing partner is a party or by which it is bound, or (B) any judgment, decree, order, statute, injunction, rule, regulation or the like or a governmental unit applicable to contributing partner, (2) result in the creation of any lien upon the property, or (3) require the approval or waiver of or filing with any person (including, without prejudice to generality, any governmental unit, agency or instrumentality). The person signing the contribution agreement on behalf of contributing partner is authorized to do so. (b) The contribution agreement constitutes, and when executed and delivered contributing partner’s closing deliveries will constitute, the legal, valid and binding obligations of contributing partner, enforceable against contributing partner in accordance with its and their terms, except as the enforcement may be limited by (i) bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting the rights and remedies of creditors generally, and (ii) general principles of equity (regardless of whether the enforcement is considered in a proceeding in equity or at law). (c) To the best of contributing partner’s knowledge, all of the files, records and documents contributing partner has delivered to the partnership or made available to the partnership (including, without prejudice to generality, the documents regarding the property) are true, correct and complete in all material respects. (d) There is no litigation, action, suit, arbitration, governmental investigation or proceeding of any kind pending or, to the best of contributing partner’s knowledge, threatened against contributing partner relating to the property or any part of the property except as set forth on Exhibit “A”. (e) True and correct copies of the most recent real estate tax bills for the property have been delivered to the partnership. No application or proceeding is pending with respect to a reduction or an increase of the taxes. There are no tax refund proceedings relating to the property which are currently pending. Contributing partner has not received written notice of any special tax or assessment to be levied against the property. (f) Contributing partner is not a “for-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

eign person” (as the term is defined in Section 1445(f)(3) of the Internal Revenue
Code of 1986, as amended). (g) There are no pending or, to the best of contrib-
uting partner’s knowledge, threatened condemnation or similar proceedings or
public improvements that will have an adverse effect on the property or any part
of the property. (h) All personal property is owned by contributing partner and, as
of the closing date, will be owned by contributing partner free from claims, liens
or encumbrances. (i) Contributing partner has not received any notice from any
governmental agency or regulatory body, any third party or any agent of contrib-
uting partner that the property violates any federal, state or local laws or regula-
tions (including without prejudice to generality, the United States Comprehensive
Environmental Response, Compensation and Liability Act of 1980, as amended,
the Atomic Energy Act, the Chemical Safety Information, Site Security and Fuels
Regulatory Relief Act, the Clean Air Act, the Clean Water Act (originally, the
Federal Water Pollution Control Amendments of 1972), the Comprehensive Envi-
ronmental Response, Compensation and Liability Act, the Emergency Planning
and Community Right-to-Know Act, the Endangered Species Act, the Energy In-
dependence and Security Act (EISA), the Energy Policy Act, EO 12898: Federal
Actions to Address Environmental Justice in Minority Populations and Low-
Income Populations, EO 13045: Protection of Children From Environmental
Health Risks and Safety Risks, EO 13211: Actions Concerning Regulations That
Significantly Affect Energy Supply, Distribution, or Use, the Federal Food, Drug,
and Cosmetic Act (FFDCA), the Federal Insecticide, Fungicide, and Rodenticide
Act (FIFRA), the Federal Water Pollution Control Amendments, the Food Quality
Protection Act, the Marine Protection, Research, and Sanctuaries Act (MPRSA,
also known as the Ocean Dumping Act), the National Environmental Policy Act
(NEPA), the National Technology Transfer and Advancement Act (NTTAA), the
Noise Control Act, the Nuclear Waste Policy Act (NWPA), Occupational Safety
and Health (OSHA), the Oil Pollution Act (OPA), the Pesticide Registration Im-
provement Act (PRIA), the Pollution Prevention Act (PPA), the Resource Con-
servation and Recovery Act (RCRA), the Safe Drinking Water Act (SDWA), the
Shore Protection Act (SPA), the Superfund Amendments and Reauthorization Act
(SARA), the Toxic Substances Control Act (TSCA) (collectively, the “Environ-
mental Laws”), workplace safety and health legislation (including without preju-
dice to generality, the Occupational Safety and Health Act and the Mine Safety
and Health Act of 1977), or disability rights legislation (including, without prej-
dice to generality, the Americans with Disabilities Act, the Fair Housing Act, and
the Architectural Barriers Act). To the best of contributing partner’s knowledge,
the contributing partner and the operation of the property are in compliance with
all applicable Environmental Laws, workplace safety and health legislation, and
disability rights legislation. Contributing partner has not caused nor, to the best of
(footnote continued on the next page)
contributing partner’s knowledge, has any other party caused any hazardous substance, waste or material to be used, generated, stored or disposed of on or transported to or from the property in material violation of any Environmental Law nor do any above ground or underground storage tanks exist on, under or about the property. For the purposes of this paragraph, “hazardous substance, waste or material” will mean all the substances as they are defined in the Environmental Laws. (j) Contributing partner has not received any notice from any governmental body having jurisdiction over the property as to any violation of any zoning, building, fire, environmental, subdivision, workplace safety and health legislation, disability rights legislation, or other governmental law or ordinance affecting the property. (k) Contributing partner has not received any notice from any insurance company or inspection or rating bureau setting forth any requirements as a condition to the continuation of any insurance coverage on or with respect to the property or the continuation of the insurance coverage at the existing premium rates. (l) To the best of contributing partner’s knowledge, there has been no default (without giving effect to any notice and cure rights) under any contract which has not to this date been cured. Contributing partner has not received notice of any claim by a party of any default which has not to this date been cured. A true, correct and complete copy of each contract (including any amendments or supplements) has been delivered or made available to the partnership. The contracts constitute the entire agreement between the parties to the contracts. There are no oral promises or agreements amending, modifying or supplementing the contracts. (m) Contributing partner has not granted any rights, options or rights of first refusal of any kind to any party which are currently in effect, to purchase or to otherwise acquire the property or any part of the property or interest in the property. (n) Contributing partner has good and marketable fee simple title to the property, free and clear of all liens, other than liens to be released prior to closing or permitted exceptions. To the best of contributing partner’s knowledge, there is no unrecorded or undisclosed legal or equitable interest in any portion of the property owned or claimed by any person. (o) Contributing partner has enjoyed the continuous and uninterrupted quiet possession, use and operation of the property without any material complaint or objection. There exists no unfulfilled obligation on the part of contributing partner to dedicate or to grant an easement or easements over any portion or portions of any of the real property. (p) Contributing partner has not received any written notice of violation of any law (including common law), statute, code, ordinance, rule, regulation, order or other requirements enacted, promulgated or issued by any applicable governmental authority (collectively, “Laws”), restrictive covenants, deed restrictions, right of way, licenses or easements affecting title to or relating to the use of the property or applicable to the property, which has not been remedied. Contributing partner has not received any

(footnote continued on the next page)
written notice of any fence dispute, common wall dispute, boundary dispute, boundary line question, water dispute or drainage dispute concerning or affecting any portion of the real property. (q) To the best of contributing partner’s knowledge, all water, sewer, electric, natural gas, telephone, drainage facilities and all other utilities required for the current use of the property are installed on the real property, are connected with valid permits, comply with all applicable laws and, to the best of contributing partner’s knowledge, are adequate to service the property for its current use. (r) Contributing partner has not received any notice that any permanent certificates of occupancy and all other licenses, permits, authorizations and approvals required by applicable governmental authorities having jurisdiction over the property have not been issued, have not been paid for, or are no longer in full force and effect. (s) To the best of contributing partner’s knowledge, neither the property nor the use or occupancy of the property are in material violation of any applicable laws. (t) To the best of contributing partner’s knowledge, the zoning of the real property permits the presently existing improvements and the continuation of the business presently being conducted on the parcel. There is no pending or, to best of contributing partner’s knowledge, contemplated rezoning of the real property. (u) To the best of contributing partner’s knowledge, there are no outstanding, defaulted or unsatisfied contracts, commitments, agreements or understandings which have been made to, with or for the benefit of any utility companies, school districts, water districts, improvement districts or other governmental authorities which could reasonably be expected to impose any obligation, liability or condition on contributing partner to grant any easements or to make any payments, contributions or dedications of money or land or to construct, install or maintain or to contribute to the construction, installation or maintenance of any improvements of a public or private nature, whether on or off the property. (v) Other than contributing partner and the tenants under the leases, no person or entity has any right to occupy the property or any portion of the property or is occupying the property or any portion of the property (pursuant to a written or verbal agreement or otherwise). (w) Contributing partner is a duly organized and validly existing under the law of the State of . Contributing partner has the full right, power and authority to enter into the partnership agreement and the contribution agreement and to transfer the property to the partnership as provided in the contribution agreement and to carry out its obligations under this contribution agreement. None of the execution, delivery or performance of the contribution agreement or the partnership agreement by contributing partner does or will, with or without the giving of notice, passage of time or both (1) violate, conflict with, constitute a default under (A) the organization documents of contributing partner or any material agreement, instrument or other document to which contributing partner is a party or by which it is bound, or

(footnote continued on the next page)
FAILURE TO INCLUDE ADEQUATE PROVISIONS REGARDING PARTNER'S REPRESENTATIONS AND WARRANTIES.

(B) violate any judgment, decree, order, statute, injunction, rule, regulation or the like of a governmental unit applicable to contributing partner, or (2) require the approval or waiver of or filing with any person (including, without prejudice to generality, any governmental unit, agency or instrumentality). The person signing the contribution agreement on behalf of contributing partner is authorized to do so. (x) The contribution agreement and the partnership agreement constitute and, when so executed and delivered, will constitute, the legal, valid and binding obligations of contributing partner, enforceable against contributing partner in accordance with its and their terms, except as the enforcement may be limited by (i) bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting the rights and remedies of creditors, and (ii) general principles of equity (regardless of whether the enforcement is considered in a proceeding in equity or at law). Attached as Exhibit “B” is a current rent roll including the following information: commencement date and dates of any modifications of the leases, suite numbers, square feet of property demised under each of the leases and rent per square foot.

467 These representations and warranties of the partnership could be like these representations and warranties: (a) The partnership is a limited partnership duly organized and validly existing under the law of the State of __________. The partnership has the full right, power and authority to enter into the contribution agreement and to accept the transfer of the property from contributing partner as provided on the contribution agreement and to carry out its obligations under the contribution agreement. None of the execution, delivery or performance of the contribution agreement by the partnership does or will, with or without the giving or notice, passage of time or both (1) violate, conflict with, constitute a default under (A) the organization documents of the partnership or any material agreement, instrument or other document to which the partnership is a party or by which it is bound, or (B) any judgment, decree, order, statute, injunction, rule, regulation or the like of a governmental unit applicable to the partnership, or (2) require the approval or waiver of or filing with any person (including, without limitation, any governmental unit, agency or instrumentality). The person signing the contribution agreement on behalf of the partnership is authorized to do so. (b) The contribution agreement constitutes, and when so executed and delivered, the partnership’s closing deliveries will constitute, the legal, valid and binding obligations of the partnership, enforceable against the partnership in accordance with its and their terms, except as such enforcement may be limited by (i) bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting the rights and remedies of creditors, and (ii) general principles of equity (re-

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Failure to include adequate closing conditions.\textsuperscript{468}
- Failure to address destruction of the property prior to closing.\textsuperscript{469}

468 Closing conditions for the partnership might include these conditions: the partnership will not be obligated to proceed with the closing unless and until each of the following conditions has been either fulfilled or waived in writing by the partnership: (a) As a condition precedent to the partnership’s obligation to acquire the property, the partnership will have received satisfactory estoppel certificates in the form of the tenant estoppel certificate attached as Exhibit “C” from the tenants under the leases. If, on or before the closing date, the condition is not satisfied or waived by the partnership, then the contribution agreement will terminate (and no party will have any further obligation in connection with this agreement except under those provisions that expressly survive a termination of the contribution agreement). A tenant estoppel certificate will not be deemed acceptable under this contribution agreement for purposes of satisfying the condition specified herein if (i) the tenant estoppel certificate discloses material adverse matters which are not consistent with the subject lease, (ii) the same are objected to by the partnership, in writing, within the sooner to occur of the closing date or three (3) business days after the partnership’s receipt of the estoppel certificate, and (iii) the matters so objected to are not cured or satisfied by contributing partner on or before the closing date, in which event the contribution agreement will thereupon terminate and no party will have any further obligation in connection with this agreement except under those provisions that expressly survive termination hereof. (b) There will have been no uncured material breach of any representation or warranty given by contributing partner herein; (c) Contributing partner will have performed all covenants and other obligations to be performed by it under the contribution agreement; and (e) The partnership will have received the title policy from the title company. Closing conditions for the contributing partner might include: contributing partner will not be obligated to proceed with the closing unless and until each of the following conditions has been fulfilled or waived in writing by contributing partner: (a) There will have been no uncured material breach of any representation or warranty given by the partnership herein; (b) The partnership will have performed all covenants and other obligations to be performed by it under the contribution agreement.

469 The contribution agreement might contain a provision like this: If, prior to closing, any of the improvements is damaged or destroyed, or if any condemnation or taking procedure is threatened or commenced, contributing partner will promptly notify the partnership in writing of the damage, destruction or condemnation.

(footnote continued on the next page)
Failure to memorialize any agreement concerning the separate fair market value of each contributed asset. This information is critical to applying Section 704(c).

Failure to include adequate provisions regarding escrow and closing.

If the aggregate cost to repair any damage or destruction under this contribution agreement is reasonably likely to exceed $1,000,000, as determined by a contractor mutually acceptable to contributing partner and the partnership, or if condemnation proceedings against the property have been commenced or are threatened, the partnership will elect by written notice to contributing partner within fifteen (15) days after receipt of contributing partner’s notice (with the closing to be extended accordingly), either: (a) To terminate this contribution agreement, and, except for any applicable indemnity provisions under this contribution agreement which expressly survive any termination, neither the partnership nor contributing partner will have any further obligation or liability under this contribution agreement; or (b) To close the transaction contemplated by this contribution agreement, and contributing partner will assign to the partnership all of contributing partner’s rights in and to any insurance proceeds (and pay the partnership the deductible amount), or condemnation award, to be paid to contributing partner in connection with the damage, destruction or condemnation. If the partnership does not make the election within the 15-day period, the partnership will be deemed to have elected not to close the transaction contemplated by this contribution agreement, and, except for any applicable indemnity provisions under this contribution agreement which expressly survive any termination, neither the partnership nor contributing partner will have any further obligation or liability under this contribution agreement. If the cost of repair is reasonably likely not to exceed $1,000,000 (as determined by a contractor mutually acceptable to contributing partner and the partnership), then contributing partner, at the partnership’s election by written notice to contributing partner within fifteen (15) days after receipt of contributing partner’s notice (with the closing to be extended as reasonably necessary), will either: (a) Cause the repairs to be promptly made in a good and workmanlike manner at contributing partner’s expense, to the extent possible prior to closing, or (b) Assign to the partnership all of contributing partner’s rights in and to any insurance proceeds (and pay the partnership the deductible amount applicable thereto). If the partnership does not make the election within the 15-day period, the partnership will be deemed to have elected not to close the transaction contemplated by this contribution agreement and, except for any applicable indemnity provisions under this contribution agreement which expressly survive any termination, neither the partnership nor contributing partner will have any further obligation or liability under this contribution agreement.
A provision regarding closing deliveries might read like this: At or prior to the closing (unless otherwise provided), contributing partner will deposit into the escrow (except as otherwise provided) each of the following instruments and documents: (a) a duly executed Warranty Deed in the form of Exhibit “C”; (b) two (2) duly executed counterparts of a Bill of Sale and Assignment and Assumption Agreement in the form of Exhibit “D”; (c) two (2) duly executed originals of an Assignment of Intangible Property in the form as Exhibit “E” (the “Assignment of Intangibles”); (d) five (5) counterpart copies of the Amendment to the Partnership Agreement in the form of Exhibit “F”, fully executed by contributing partner; (e) fully executed originals (or copies in the event the originals are not available) of all assumed contracts; (f) originals (or certified copies in the event that originals are not available) of the leases and all correspondence, memoranda, files and reports related to the leases; (g) fully executed originals of tenant estoppel certificates from all of the tenants under the Leases, which will be satisfactory to the partnership; (h) originals (or copies in the event originals are not available) of all assignable licenses, permits, warranties and guarantees relating to the use, occupancy or operation of the property; (i) all books, records, and files of contributing partner available to the contributing partner relating to the property including architects’ drawings, blueprints and as-built plans for the property; (j) an affidavit stating contributing partner’s United States taxpayer identification number and that contributing partner is a “United States person”, as defined by Internal Revenue Code Section 1445(f)(3) and Section 7701(b), in the form attached as Exhibit “F”; (k) a certification that contributing partner is not aware of any uncured material breach of any representation, warranty or covenant of contributing partner; (l) notices to tenants under the leases in the form attached as Exhibit “G”, duly executed by contributing partner, informing the tenants of the change of ownership of the property; (m) a settlement statement prepared by the title company; (n) all keys and combinations to all locks on the improvements; (o) such instruments, documents and certificates as are customarily required by the title company to be executed by contributing partner as a condition to the issuance of the title policy; (p) the title policy; and (q) such other documents and instruments as may be required by any other provision of this agreement or as may reasonably be required to carry out the terms and intent of this agreement. At the closing, the partnership will deposit into the escrow each of the following instruments and documents: (a)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Failure to allocate closing and transfer expenses.\(^\text{471}\)
- Failure to allocate transfer taxes.
- Failure to address title insurance and endorsements.
- Failure to address prorations and adjustments.\(^\text{472}\)

five (5) counterpart copies of copies of the Amendment to the Partnership Agreement in the form of Exhibit “F”, each fully executed by all partners other than the contributing partner; (b) two (2) fully executed counterparts of the Bill of Sale and Assignment; (c) a certification that the partnership is not aware of any unsecured material breach of any representation, warranty or covenant of the partnership in this agreement; (d) deliver to the title company instruments, documents and certificates as are customarily required by the title company to be executed by the partnership as a condition to the issuance of the title policy; (f) a settlement statement prepared by the title company; and (g) such other documents and instruments as may be required by any other provision of this agreement or as may reasonably be required to carry out the terms and intent of this agreement.

\(^\text{471}\) The contribution agreement might provide: At or prior to closing, contributing partner will pay (i) the premium associated with the title policy, (ii) the costs of providing to the partnership all information to be reviewed by the partnership pursuant to this contribution agreement including, but not limited to, the property documents, (iii) all fees for releasing liens and encumbrances, (iv) the lease costs, (v) one-half of any escrow fees or similar charges payable to the escrow agent or the title company, and (vi) any real estate or personal property transfer or sales taxes, excise taxes, deed or documentary stamps, document taxes and similar taxes or charges with respect to the transfer of the property. At or prior to closing, the purchaser will pay (i) all recording fees for recording the deed and any other conveyance documents the partnership elects to record, (ii) the cost for any extended coverage and/or endorsements to the title policy, and (iii) one-half of any escrow fees or similar charges payable to the escrow agent or the title company.

\(^\text{472}\) A proration and adjustments provision might read something like this: The partnership will apportion these items as of the closing date (with the partnership being deemed to own the property for the entire day of the closing date): (a) All rent due under the leases will be apportioned as of the closing date, regardless of whether or not such amounts have been received by transferor. The partnership will pay to transferor any such rent or other revenues from the property actually collected which are applicable to the period preceding the closing date. If there are arrearages under the lease as of the closing date, transferor will receive a credit at closing for such arrearages and the partnership will thereafter have the right

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Problems with the tax protection agreement if the property is sold.
- Failure to address material changes prior to contribution.
- Failure to consider the many other issues that typically are addressed in a purchase and sale agreement.

The in-kind contribution of property to a partnership poses practically all of the challenges of a purchase and sale of property. The partnership agreement or a separate contribution agreement can serve as a surrogate for a purchase and sale agreement. A purchase and sale agreement can serve as a starting point for a contribution agreement. Simplicio’s partnership agreements fail to address many problems that a purchase and sale agreement normally would address.

Simplicio relies on his view that the partners will just get along and love one another.

to collect and keep any such arrearage collected. (b) Transferor will pay as of the closing date any and all leasing commissions, free rent, allowance payments or other concessions granted to any tenants in connection with the leases (collectively, “Lease Costs”) that are or will become due and payable on or prior to the closing. The partnership will receive a credit for any Lease Costs which are not due until after the closing. (c) The partnership will receive a credit for the total sum of all lease deposits paid by the tenants under the leases, and any interest earned thereon which, by the terms of the subject lease, is refundable to such tenants or, if applicable, transferor will assign to the partnership any letter of credit held by transferor in connection with the leases and pay any fee related thereto. (d) The partnership will receive a credit for any rent abatement and/or reduction and/or other unexpired concessions under the leases to the extent they apply to any period after the closing. (e) If any of the leases contain tenant obligations for taxes, common area expenses, operating expenses or additional charges of any other nature, and transferor has collected any portion of these amounts in excess of amounts owed by the tenants under the leases, there will be an adjustment and credit given to the partnership on the closing date for such amounts collected. (f) Except to the extent, if at all, that utility charges are billed to and paid directly by the tenants under the leases, all utilities will be prorated outside of closing. (g) Except to the extent, if at all, that taxes and assessments are billed to and paid directly by the tenants under the leases, the real property taxes and assessments will be prorated at closing. (h) If any of the prorations cannot be definitely calculated as of the closing date, they will be estimated at closing and calculated as soon after closing as feasible. Either party owing the other party monies will promptly pay this sum once the prorations have been accurately calculated.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

39. Inattention to Conversion of Up-REIT Units.

The real estate partnership may be an up-REIT partnership.473 A partner who enters an up-REIT partnership typically plans, at some date, to convert his up-REIT units into publicly-traded real estate investment trust stock. He then will sell the stock in a public market. Simplicio has many ways to compromise the conversion terms. Some of the drafting considerations that concern Salviati include:

- What is the notice period between conversion notice to the real estate investment trust and conversion?
- What is the conversion formula?
- If the partnership will convert up-REIT units on a look-back averaging method, what is the formula? Is this formula fair to the parties? Is this formula predictable?
- How will preferred up-REIT units be converted into common stock of the real estate investment trust?
- What is the notice period between conversion notice and conversion?
- What is the valuation date?
- What protection does the converting unitholder have for market price fluctuations between conversion notice and conversion?
- How does the conversion work if the real estate investment trust goes private and there no longer is a public market for its stock?
- Is the unitholder who has conversion rights protected against the possibility that the real estate investment trust will go private?
- Is there a standstill period during which a unitholder cannot convert?
- How is the unitholder protected during this period?
- Is the unitholder guaranteed that the real estate investment trust shares that he receives on conversion will be registered shares?

473 Note, in connection with up-REIT contributions, the promulgation of proposed regulations on “bottom” guarantees in REG-119305-11; 79 F.R. 4826-4839 (January 30, 2014). See note 93.
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

- Is the unitholder guaranteed that the real estate investment trust shares that he receives on conversion will be listed shares?

### 40. Borrowing from Partners and Emergency Loans

The partnership may need to borrow on an emergency basis. Simplicio can compromise his partnership agreement by not providing a mechanism for emergency loans from partners or not providing for other loans from partners. Simplicio also can compromise his partnership agreement by failing to provide a detailed mechanism for determining the terms of the emergency loans from partners or other loans from partners.


Draftsmen often give little consideration to management provisions. Views on appropriate management provisions and management rights can differ considerably depending on the situation of the partner. The best management terms are a question of point of view.

Basic management issues that Salviati considers include:

- Do the management/governance provisions make sense considering the size, scope, and business of the partnership?
- Do the management/governance provisions provide adequately for day-to-day management of the partnership business?
- Do the management/governance provisions provide adequately for extraordinary business decisions of the partnership?
- Do the management/governance provisions meet the participation and informational needs of nonmanaging partners?
- Do the management/governance provisions deal reasonably with expected extraordinary events?
- Do the management/governance provisions deal adequately with managerial disagreements?
- Do the management/governance provisions help the situation when the business or partner relations are not going smoothly?
- How do the management/governance provisions handle deadlocks?
- Do the management/governance provisions deal adequately with succession?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Is the partnership agreement clear on who makes which decisions?
- Is the size of the venture of nature of business of the venture substantial enough that the partnership should have a management committee to deal with larger policy matters?
- Is the size of the venture of nature of business of the venture substantial enough that the partnership should have officers?
- Is the nature of the partnership such that it should have a manager who may not be one of the partners?
- Should owners have equal management rights?
- Should management rights change as the venture matures or upon specific events?
- How does the entity resolve disputes?
- How is the entity going to be run when investors disagree over management direction or philosophy?
- What provisions should the partnership agreement have if the investors have paralyzing disputes and find that their competing interests are irreconcilable?
- How should the partnership agreement deal with management deadlocks?
- What management issues (if any) can be arbitrated or mediated?
- Should deadlocks trigger a buy/sell?
- Should deadlocks trigger a liquidation of the venture?
- Should the entity have a manager? If so, what are his rights, powers, duties, and obligations? Are there to be stated qualifications? How is he selected and removed? How is he compensated?
- Should the entity have a management committee? If so, what are its rights, powers, duties and obligations? How are members selected and removed? How are members compensated? How will the management committee work? How will the management committee work with the manager?
- What are appropriate provisions concerning the manager and management?
- If the entity is a limited liability company, is the entity member managed or manager managed?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• Does the partnership agreement provide excessive management fees for the managers?
• Are management fees based on reasonable operating expenses and reasonable salaries?
• Have the investors received a model of management fees?
• What are the matters included within management fees and what expenses are separately reimbursed?
• Do management fees take into account the lower expenses that are generally associated with the formation period?
• What is the difference between a member-managed and a manager-managed limited liability company?
• If there is more than one manager, how is power apportioned among the multiple managers?
• How can a member or manager proceed with conduct that otherwise would violate the duty of loyalty?474

474 The duty of loyalty is basically a duty not to compete with the partnership and a duty to deal at arm’s-length with the partnership. See, e.g., 6 Delaware Corporations Code § 15-404(b) (“(b) A partner’s duty of loyalty to the partnership and the other partners is limited to the following: (1) to account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct or winding up of the partnership business or affairs or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity; (2) to refrain from dealing with the partnership in the conduct or winding up of the partnership business or affairs as or on behalf of a party having an interest adverse to the partnership; and (3) to refrain from competing with the partnership in the conduct of the partnership business or affairs before the dissolution of the partnership.”). See 6 Delaware Corporations Code § 15-103(f) (“A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.”); 6 Delaware Corporations Code § 15-103(e) (“A partner or other person shall not be liable to a partnership or to another partner or to another person that is a party to or is otherwise bound by a partner-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• Who has authority to commit the partnership within the ordinary
course of the activities of the partnership?
• Who has authority to commit the partnership outside the ordinary
course of the activities of the partnership?
• What happens if there is a management deadlock?
• What are the duties and responsibilities of the manager?
• What are the powers of the manager?
• Is there a business plan and budget? How are they generated and
approved? How much do they control the manager? What discre-
tion does the manager have? What departures from plan are per-
mitted? When are additional approvals required?
• What is the standard of care to which decisions of the manager are
subject?
• Does the partnership have a gross negligence standard of care or an
ordinary care standard?
• To what extent does the business judgment rule apply to the con-
duct of managers and members?
• Does a member or manager have an obligation to refrain from
conduct that furthers the member’s own interest as opposed to the
interests of the partnership?
• What are the limitations on the powers of the manager?
• Are there limitations on investment concentration?
• What is the authority of the manager to invest in debt instruments,
publicly traded securities, and pooled investment vehicles?
• Is there a diversification requirement for investments?
• Are particular investments prohibited?
• What is the authority of the manager to invest in partnerships and
similar entities?
• Who has the legal power and authority to bind the partnership?
• What powers does the manager have?

ship agreement for breach of fiduciary duty for the partner’s or other person’s
good faith reliance on the provisions of the partnership agreement.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What can the manager not do?
- How much control should the manager have?
- If there is more than one manager –
- What are an individual manager’s rights?
- How are rights partitioned between managers?
- Do the managers have to act collectively?
- How do the managers show that they have acted collectively?
- How do managers reach decisions?
- What happens if an individual manager is ill or otherwise indisposed?
- What are the manager’s required qualifications?
- What restrictions does the partnership agreement contain concerning managers investing in other business opportunities?
- Are fees of advisory entities employed by the partnership reviewed and approved by limited partners?
- Are managers restricted from promoting or investing in competing partnerships? How is “competition” defined?
- Is there a definition of key men in the management entity who are required to devote all or substantially all of their time to the management of the partnership?
- How do partners remove the manager?
- What are grounds for removing the manager?
- Is removal limited to cause? If so, what is “cause”?
- How do partners select a new manager?
- Can the members buy out the manager on listed triggers?
- Can the members bring in new management on listed triggers?
- What happens to the manager if he is removed?
- Are removal provisions constructed so that the members can quickly remove the manager?
- What obligation does the partnership have to advance expenses of the manager?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and
Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- If there is a management committee,
- What is the composition of the management committee?
- How do the partners select management committee members?
- What is their term?
- How are they replaced?
- Who designates successors?
- What are its powers and the limitations on its powers?
- When does it meet? Where?
- What vote is required to make decisions?
- What are the management committee’s approval rights?
- What other provisions relate to the management committee?
- If there is a committee representing the interests of nonmanaging partners,
  - What is the composition of the committee?
  - How are they selected?
  - What are their powers?
  - Do they approve related party transactions with the managers (such as related party service agreements, related party transactions, and investments in competing partnerships)?
  - What matters are subject to the consent of the committee?
  - Does the committee have the right to approve auditors?
  - Does the committee have any type of supervisory role concerning partnership expenses?
  - What is the expected time commitment of committee members?
  - Are meetings of the nonmanaging partners committee open?
  - How often does the committee meet?
  - What other provisions should control the meeting of the nonmanaging partners committee?
  - Does the partnership agreement contain a procedure for the auditors to present issues directly to the nonmanaging partners’ committee?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Is there a requirement for the nonmanaging partners committee to approve a change in auditors?
- What is the apparent authority of a member under the common law of agency?
- Should the partnership file a statement of authority with the Secretary of State?
- If the partnership owns real property, should the partnership file a statement of authority with the county recorder?
- Who has the power to do what?
- What restrictions limit the power of an individual member?
- If the partnership is a limited partnership, what management or approval rights can limited partners have?
- How much control should the members have?
- What approval rights should members have?
- What events ratchet up the management rights of the nonmanaging members?
- Who has the right to amend the partnership agreement?
- Who has the right to dissolve the partnership?
- Who has the right to dispose of partnership assets?
- Who has the right to change the purpose of the partnership?
- Who has the right to enter mergers or other reorganizations?
- How is a “majority of interest” determined for voting?
- What information rights do the members have?
- Does the partnership have a clear investment or business strategy?
- Are there appropriate limitations on investment and industry concentration of investments?
- Does the service partner participate in income from temporary investment of capital contributions?
- Does the partnership agreement pay profits from the service partnership interest on recapitalizations?
- Does the partnership agreement contain specific insurance requirements? These requirements may address issues such as title
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

insurance, officer’s insurance, builder’s risk insurance, business
income and extra expense insurance, business interruption insur-
ance, loss of rental income insurance, boiler and machinery insur-
ance, commercial general liability insurance, workers’ compensa-
tion insurance, employer’s liability insurance, flood insurance,
earthquake insurance, earthquake sprinkler insurance, architects
and engineer’s insurance, contractors’ and subcontractors’ insur-
ance, environmental insurance, and vehicle insurance?

• What are the specific requirements for the underwriter?
• What are the minimum insured amounts
• What special disclosure obligations does management have to
  nonmanaging partners?
• Financial reports.
• Conflicts of interest.
• Inquiries made by legal authorities or regulatory agencies.
• Material adverse developments in the business of the partnership.
• Breaches of provisions of the partnership agreement or fiduciary
  breaches.
• Material liabilities of the partnership.
• Changes in key persons in the management company.
• Changes in voting control of the manager.
• Sale of the manager.
• Public offerings by the manager.
• Formation of other investment vehicles by the manager.
• Information concerning partnership investments, including concen-
  tration of partnership investments.
• Leverage of partnership investments.
• Market developments that have material effects on the business
  prospects of the partnership.
• Changes of partnership auditors.
• Changes of partnership counsel.
• Provision for the nonmanaging partners committee to engage
counsel at the expense of the partnership.
• Should the partnership have an agreed standardized form of reporting to nonmanaging partners?

• What are Major Decisions that require nonmanaging partner approval and possibly unanimous consent? Major decisions might include these decisions, among others:
  • To approve any annual budget, business plan, leasing guidelines, or standard form lease, or any amendment to any of these documents.
  • To sell, to exchange, to lease, to mortgage, or otherwise to transfer all or any part of any partnership property or any interest in any partnership property, except as provided for in the last approved business plan.
  • To purchase or otherwise to acquire any real or personal property, fixtures or equipment.
  • To enter into, to amend, to modify or to terminate any contract, or any series of similar contracts (i) for amounts or purposes not consistent with then-current annual budget (except for permitted additional expenses), (ii) the term of which shall exceed one year (excluding leases entered into in accordance with the partnership agreement), or (iii) with respect to service contracts, that are not terminable, without cause, by the partnership upon thirty (30) days’ written notice.
  • To make any capital expenditures during any fiscal year in excess of the expenditures provided for in the annual budget for the year.
  • To incur any partnership indebtedness (either secured or unsecured) except short-term trade debt consistent with then-current annual budget, emergency loans, and default loans.
  • To prepay, to recast, to extend, to amend, to modify, to consolidate, to increase, or to refinance any mortgage or other loan affecting a partnership property, the partnership or any subsidiary.
  • To take any action, to cause any subsidiary to take any action, or to fail to take any action or allow or cause any subsidiary to fail to take any action under any documents evidencing or securing any financing of the property, the part-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

nership or any subsidiary or any refinancing of any of the foregoing.

- To issue guaranties or to become liable as a surety, accommodation party or otherwise in respect of the indebtedness or obligations of another person.
- To settle any audits with taxing authorities.
- To acquire stock, partnership interests or other beneficial interests in any person, or to make any other investment in, or loans or advances to, any person, except for investments in (i) the subsidiaries, (ii) direct obligations of the United States of America or its agencies, (iii) obligations guaranteed by full faith and credit of the United States of America, or (iv) certificates of deposit issued by a commercial bank having a net worth in excess of One Billion Dollars ($1,000,000,000) or the other net worth as is approved by the partners and chartered under the laws of the United States or one of the States, or (v) repurchase agreements. The obligations or certificates of deposit in each case shall have remaining maturities of not more than one year.
- To enter into, to modify, to amend or to terminate any property management agreement or leasing agreement with a listing agent for any part of any property.
- To permit the replacement of any property manager or listing agent retained by the partnership or a subsidiary for a property.
- To approve any matter that, under any management agreement or agreement with a leasing agent, requires the approval of the partnership, except for the approval of expenditures consistent with the annual budget then in effect or permitted additional expenses.
- To settle any claim in excess of Five Hundred Thousand Dollars ($500,000) against an insurer in respect of property or casualty insurance or liability insurance.
- Except in accordance with the leasing guidelines, (i) to terminate or to agree to accept the surrender or cancellation of any lease for occupancy of space in any property prior to the expiration of the stated term, or (ii) to agree to the modification of the terms of any lease for occupancy of space in any property.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- To approve plans and specifications, and material modifications thereof, for the construction of improvements or alterations, except (i) in accordance with the annual budget then in effect, or (ii) for any permitted additional expenses.
- To change the name of a property or any portion thereof.
- To confess judgment against the partnership, any assets of the partnership, or any material component (including any subsidiary).
- To conduct, to settle or to compromise any litigation, mediation, arbitration or other proceeding involving a claim against the partnership or any subsidiary in connection with any property in excess of Five Hundred Thousand Dollars ($500,000).
- To commence any litigation, mediation, arbitration or other proceeding on behalf of the partnership or any subsidiary other than litigation to enforce leases and service contracts.
- To consent to or to acquiesce in any change to the zoning or other land use status of any property.
- To engage or to employ accountants, attorneys and other professional advisors, subject to stated exception or limits for minor matters.
- To establish reserves for capital replacements, working capital or any other item in any year in excess of those provided in the annual budget for the year.
- To impose a condominium declaration or other common ownership regime upon any property.
- To apply for zoning changes.
- To undertake application for subdivision of the property.
- To apply condemnation awards or insurance proceeds in excess of Five Hundred Thousand Dollars ($500,000) to the restoration or repair of any property unless required by (i) the terms of any loan documents evidencing and/or securing any financing of the partnership that has been approved by the partners or (ii) any lease.
- To consent to or to acquiesce in any change in the real property tax status of any property.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- To require any capital contributions other than in accordance with the terms of the partnership agreement.
- To file on behalf of the partnership as debtor for bankruptcy, receivership, insolvency or any other action for the protection of debtors.
- To enter into joint venture or partnership arrangements with any other person.
- To enter into any contract, mortgage, limited liability company agreement, partnership agreement, limited partnership agreement, or other instrument or agreement with respect to an action that is otherwise (but for this provision) a Major Decision.
- To take any other action that may not be delegated by the members of a limited liability company under the Act.
- A decision on any matter or action of the partnership if, in the reasonable determination of the pension fund partner, the decision would (i) have an adverse effect on the tax exempt status of the pension fund partner, (ii) create a reasonable possibility that any non-de minimis income of the partnership allocated to the pension fund partner will be taxed as unrelated business taxable income, or (iii) result in a non-exempt “prohibited transaction” under ERISA or the Code.
- To remove a manager, managing partner, or an officer.
- To select a replacement manager, managing partner, or an officer.
- To agree to or to alter the compensation of a manager, managing partner, or officer.
- To approve portfolio investment guidelines.
- To approve a portfolio investment advisory agreement.
- To approve contracts and transactions with affiliates of the manager or a member.
- To approve capital calls.
- To release or to compromise partnership obligations.
- To alter or to compromise an obligation to contribute to the partnership.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements

Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- To admit new partners to the partnership.
- To approve a merger, conversion, or domestication.
- To undertake any other act outside the ordinary course of the partnership’s activities.
- To amend the partnership agreement.
- To wind up and to dissolve the partnership.

- Should the partnership agreement modify the duty of care?\(^{475}\) What protection does the partnership have from a partner running amok of the partnership agreement modifies the duty of care.

- Can the partnership agreement modify the contractual duty of good faith?\(^{476}\)

\(^{475}\) The duty of care can be somewhat flexible under different acts. It can, for example, include the business judgment rule – to act to act with the care that a person in a like position would reasonably exercise under similar circumstances and in a manner the partner reasonably believes to be in the best interests of the partnership. In discharging this duty, a partner may rely in good faith upon opinions, reports, statements, or other information provided by another person that the partner reasonably believes is a competent and reliable source for the information. This duty of care also can be limited to a duty to refrain from conduct that is grossly negligent or reckless, intentional conduct injurious to the partnership or a knowing violation of law. The duty of care also can be a duty to act in good faith and in a manner that the partner or manager believes to be in, or nor opposed to the interests of the partnership and with the care that an ordinarily prudent person in a similar position would use under similar circumstances. This duty also may be a duty to refrain from acting with deliberate intent to cause injury to the partnership or from acting with reckless disregard for the best interests of the partnership.

\(^{476}\) The duty of good faith and fair dealing is sometimes considered a fiduciary duty and sometimes is limited to a contractual duty – an implied contractual covenant. This duty can differ from state to state. This duty may be a general contractual duty that would exist under any contracts entered into in the state – or perhaps contracts where a special relationship exists, such as the relationship between an agent and principal or other situations in which a relationship implies trust and reliance. The duty of good faith and fair dealing perhaps a partner to act in the partner’s self-interest. The duty of good faith and fair dealing is a limited duty that courts generally are reluctant to expand. The duty of good faith and fair dealing clearly is a lower standard than the fiduciary standard to which a trustee is
Should the partnership agreement modify the contractual duty of good faith?

Can the partnership agreement provide indemnity or exculpation of persons subject to the duty of good faith?

What fiduciary duties, if any, does a member have beyond the duties of loyalty and care?

What is the duty of loyalty of a partner of a partnership?

What is the duty of care of a partner of a partnership?

Can an exculpatory provision exculpate or otherwise shield against a partner’s claim of oppression?

Are the manager’s powers subject to “the manager’s sole, reasonable discretion” or to “the manager’s absolute discretion”?

What decisions require a majority vote?

What decisions require a supermajority vote?

Can a nonpartner have veto authority over amendments to the partnership agreement?

Can an assignee of a partnership interest object to a management decision?

What does the partnership do if the partners fail to approve a budget?

Does the partnership agreement provide a practical procedure to continue business operations?

Are partners able to vote on decisions in which they are directly financially interested?

How does the partnership break management impasses?

How is the partnership agreement amended?

When can a major or a partner make a loan to the partnership? On what terms?

The duty of good faith and fair dealing can limit a partner and require that the partner not act oppressively and in bad faith. One of the possible aspects of the covenant of good faith and fair dealing is reasonably to share or to disclose information when needed by the other partners.
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

- Is the management fee computed based on gross income, gross receipts, net income, or some related index?
- Does the management fee differ during the formation and liquidation of the fund?
- Are there offsets of management fees against the percentage interest of the manager?
- Are management fees based on reasonable operating expenses and reasonable salaries?
- What expenses are included in the management fees (such as general and administrative items, overhead, staff compensation, deal sourcing, travel, postage, information technology, and communications).
- Do management fees take into account different levels of fees during different periods of the partnership’s life?
- Can the management fee agreement make the manager a tax partner?
- Have the passive investors been provided with a model that shows the computation of management fees?
- Is the manager an employee of the partnership subject to protection under employment laws?
- Is the manager subject to wage withholding?
- What is the treatment of allocations to the managing partner with respect to FICA and Section 1411?
- Is the manager the same entity or person as the managing partner or is the management fee paid to an affiliate?
- Can the manager convert his future management fee into a partnership interest?
- When can the conversion option be exercised?
- Is the management fee convertible into a preferred or a common partnership interest?
- What are the tax effects of the conversion to the converting partner and the partnership?
- How is the partnership interest valued for purposes of the conversion?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does the partnership rebook capital accounts at the time of the conversion? How does the partnership value assets for purposes of the rebooking?
- Will the converted interest be treated as a capital interest or as a profits interest?
- Will special income allocations be made with respect to the converted interest so that the new interest ends up on a par with other interests in the partnership with respect to capital?
- Can a true “profits” partnership interest be achieved if the partnership does not revalue assets and redetermine capital accounts.
- What rights do members have to remove the manager or a managing partner?
- Who has the right to remove the manager?
- Must the partnership agreement require removal for cause?
- What is cause?
- Who determines cause?
- How are disputes resolved?
- What happens on removal of the manager or managing partner?
- When can a partner’s conduct on behalf of the partnership impose liability on the partner on account of the partner’s personal conduct?
- What happens when a member steps in and acts for a manager who is indisposed?
- What are the provisions for replacing the manager?

Salviati may include these provisions when a labor union pension plan is a partner.

- All on-site construction (including capital improvements, interior or exterior, tenant improvements, repair and replacement work, and any new construction) at any property (i) will be performed solely by contractors and subcontractors employing craft workers represented by unions affiliated with the local and/or national Building and Construction Trades Council, American Federation of Labor – Congress of Industrial Organizations, and/or The Building and Construction Trades Department, American Federation of Labor – Congress of Industrial Organizations, and (ii) all employ-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

ment will conform to traditional craft jurisdictions in the area of the property.

- If any construction of the exterior or structural portions of the improvements on any property uses components that are fabricated off-site (e.g., exterior insulation and finishing system or brick panel systems), the components must be fabricated in a union-signatory plant and must be delivered to the construction site by a union-signatory transportation partnership.

- The partnership (i) will include the labor covenant in each contract entered into by the partnership in connection with any construction at any property, and (ii) will include in each contract entered into by the partnership in connection with any construction at the property a requirement that each contracting party include the labor covenant in each of its subcontracts.

- If casualty insurance proceeds or condemnation awards are permitted to be applied to reconstruction, replacement or repair of the improvements, the partnership will be obligated to cause the labor covenant to be observed with respect to reconstruction, replacement or repair.

- The labor covenant will be included in any new lease.

- The labor covenant will be included in all contracts with any contractors or subcontractors in connection with any construction work under a lease.

- The labor covenant will be required for any work under a tenant improvement contract.

- The partnership will use commercially reasonable efforts to comply with the labor covenant in connection with any renewals of any leases.

- The partnership will enter into all service contracts with contractors and subcontractors who employ only employees who are represented by unions affiliated with the local Building and Construction Trades Council, American Federation of Labor – Congress of Industrial Organizations and/or The Building and Construction Trades Department, American Federation of Labor – Congress of Industrial Organizations.

- In connection with entering into subcontracts and other third-party contracts with respect to the project, the partnership will exercise reasonably diligent efforts to comply with the pension fund’s re-
porting programs and policies concerning service-disabled veterans and responsible contractors, which reporting programs and policies are attached as an exhibit. The partnership will reasonably cooperate and assist Investor with the pension plan’s reporting requirements under these programs and policies applicable to the project.

- A building maintenance employees will be represented by a union affiliated with the American Federation of Labor – Congress of Industrial Organizations, or operations will be subject to appropriate card check and neutrality agreements.

- The partnership will require all contractors and subcontractors of whatever tier to agree to submit all construction trades jurisdictional disputes to final and binding arbitration through the procedures of the “Plan for the Settlement of Jurisdictional Disputes in the Construction Industry” as jointly established and administered by the Building and Construction Trades Department of the American Federation of Labor – Congress of Industrial Organizations and various construction industry employer associations. If any dispute cannot be so resolved through the Plan, then all contractors and subcontractors of whatever tier will agree to submit the dispute to final and binding arbitration through the procedures established and administered by the American Arbitration Association in conformity with the organization’s Commercial Arbitration Rules, Expedited Procedures and with an experienced labor arbitrator who is a partner of the National Academy of Arbitration.

- The partnership will observe and will cause the partnership or any subsidiary to observe and will require all contractors and subcontractors performing work on the property to observe, all local, state and national laws (including those labor and employment laws pertaining to equal employment opportunity, insurance, wages and overtime, union organizational rights and occupational safety and health).

- The partnership will use commercially reasonable efforts to require any non-union contractors to work in harmony with and not to interfere with contractors employing union labor or the use and operation of the properties.

- The partnership will not unlawfully discriminate against any employee or applicant for employment relating to the project, because of race, religion, color, national origin, ancestry, physical handicap, medical condition, marital status, age (over 40) or sex. The partnership will ensure that the evaluation and treatment of their
employees and applicants for employment relating to the project
are free of discrimination. The partnership will comply with the
applicable provisions of all applicable federal and state statutes and
regulations relating to discrimination on the basis of race, religion,
color, national origin, ancestry, physical handicap, medical condi-
tion, marital status, age (over 40) or sex. The partnership will give
written notice of their obligations under this clause to labor organi-
izations with which they have a collective bargaining or other
agreement. The partnership will include the foregoing nondiscri-
mination compliance provisions in all contracts to perform work or
provide services under the partnership agreement. The partnership
will conduct its activities relating to the project in accordance with
Title VI of the Civil Rights Act of 1964 and the rules and regula-
tions promulgated therein.

- The partnership will cause all contractors and subcontractors,
while performing services with respect the partnership, to observe
all local, state, and national laws (including, without prejudice to
generality,, by way of illustration, those pertaining to applicable li-
censing and permitting, insurance, withholding taxes, minimum
wage, and health and occupational safety).

For some partners, it is important that partners have the right to cause a
sale of the property if there is a deadlock on management philosophy.

Simplicio relies on whatever his old form provides. This is much less ex-
pregnate for his drafting.

All partners should want the manager to have enough power for the busi-
ness to succeed. The manager may want to have unrestricted power to do practi-
cally anything. The manager also may want to minimize his reporting obligations
to other partners. To the extent that other partners have consent rights, the mana-
ger may wish to streamline consents by providing for quick notice provisions and
automatic consent unless a partner objects within a short period of time.

Other partners may have different interests. They may want active partici-
pation in management decisions. They may want regular and extensive reports.
They may want rights of consultation. They may merely want to be informed of
decisions. They may want to consent to a class of listed business decisions.

Other partners – particularly money partners and institutional investors –
may want the right to take over the business, to participate, or to have enhanced
approval rights in the event of various triggers in the partnership agreement. They
may want to be able to oust the manager or to buy out his interest or to bring in a
replacement manager on prescribed events. These provisions need to be drafted
with care and precision. They often indicate an environment that is close to litiga-
tion. Simplicio believes that these provisions can be scrutinized carefully when partners invoke them.

The partners might consider remedies when irremediable rifts divide the partners or divide management from investors. Some advisors believe that the best solution is some sort of breakup of the partnership relationship – either a sale of assets or a buyout of dissenting interests. Simplicio merely uses what his form provides.

An important part of management is the provision of management fees. Salviati drafts provisions for management fees that are unambiguous. Salviati also includes provisions for modification and adjustment of fees, where appropriate.

42. Partnership Meeting Provisions.

Partner meetings may or may not be required. Meeting provisions often are *pro forma* and abbreviated. The relevant test is whether the meeting provisions are sufficient to permit the partnership to undertake its normal operations. Simplicio has a variety of opportunities to draft compromised meeting procedures when he drafts a partnership agreement.

Salviati provides detailed rules for calling meetings and meeting rules. Some provisions that might be included in partnership meeting provisions drafted by Salviati include:

- Who can call a meeting and when?
- What does the partnership agreement require for a meeting notice?
- Who sends out the meeting notice?
- What minimum time does the partnership agreement require between a meeting notice and the meeting?
- Are meetings limited to noticed items?
- What is the notice waiver procedure?
- What matters can partners consider at a meeting?
- What meetings does the partnership agreement require?
- What meetings does the partnership agreement allow?
- Does the partnership agreement require an annual partner meeting? When is it?
- What does the partnership agreement require to authorize special meetings?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

• Who can attend meetings?
• Does the partnership agreement provide for telephonic participation in partner meetings?
• Does the partnership agreement provide for internet participation in partner meetings?
• Who can vote at meetings?
• What can they vote on?
• What can meetings not consider and partners not vote on?
• What proxy procedures does the partnership agreement require?
• What proxy challenge procedures does the partnership agreement provide for?
• Who determines the validity of a proxy?
• Is there voting by class of interests?
• Is there provision for closing transfer books in connection with pending meetings?
• How is the voting record date determined?
• Who is entitled to vote at partnership meetings?
• What are the procedures regarding adjourned meetings?
• What rules of order are used at meetings?
• Who presides at meetings?
• What is the meeting quorum?
• What happens if the current meeting drops below a quorum?
• Is there provision for voting by written consent?
• Where are meetings held?

Simplicio relies on the meeting provisions in his form agreement.

In drafting the management provisions, consider:

• The business positions and sophistication of the various partners.
• The business objectives of the various partners.
• The need for the manager to be able to manage the project, but also the need for nonmanaging partners to have appropriate controls over the
business and perhaps the ability to remove the manager if things are not going well.

- The possibility of triggers to change the management rights of the parties.
- The possibility of the need to being in new management and the economics associated with this transition.
- What does the partnership do if the manager fails to meet defined economic objectives?
- What does the partnership do if the manager is guilty of improprieties as manager.
- What does the partnership do if the manager is guilty of improprieties outside of his capacity as manager?

43. Fail to Provide Realistically for the Budget and Budget Contingencies.

Salviati often includes provisions for an annual budget. Salviati’s partnership agreement may set forth the requirements of the budget in different levels of detail. A sophisticated partnership agreement may specify many of the line items in the budget – or may attach an initial budget as a model for future budgets. The partnership agreement often will require the managers to manage the finances of the partnership within the requirements of the budget. The budget may contain line items for contingencies, or may require that all expenditures not exceed a specified percentage on a line item basis or on an aggregate basis. Salviati’s partnership agreement provides tolerance for the finances of the partnership not precisely conforming to a planned model. Simplicio drafts a shorter and less expensive partnership agreement by avoiding all of this budget nonsense.

Salviati’s partnership agreement contains provisions for approval of the budget and amendments to the budget. These provisions contain directions to permit continued operations if the partners face an impasse on the budget.

Budget provisions in the agreement drafted by Salviati deal with issues such as –

- Who prepares the budget.
- Form of the budget (including, without prejudice to generality, required line items).
- Budget approval.
- Whether manager is constrained by the budget.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Overruns and unexpected expenditures.
- Budget revision.
- Permitted continuing operations if the partnership does not approve the budget or revisions?

44. Fail Adequately to Provide for Financial Reports.

Most partnerships have annual financial reports. Financial reports may be as modest as a simple balance sheet or income statement. Another partnership may have detailed requirements for regular long-form financial reporting. Some financial reports are prepared by accounting firms after the year. The accountants may certify the financial statement to present the financials in accordance with Generally Accepted Accounting Principles, as promulgated by the American Institute of Certified Public Accounts (AICPA) and utilized by the accounting profession in the United States. Simplicio specifies that his partnerships will use GAAP as applied to the cash method of accounting.

A partnership agreement that Salviati drafts for a large partnership might require:

- A detailed unaudited monthly financial report, perhaps with reconciliation of actual items to budget items. The partnership agreement might require these items:
  - Balance sheet.
  - Quarterly profit and loss statements
  - Quarterly profit and loss statements showing year-to-date results.
  - Schedule showing changes from the immediately prior quarter.
  - Schedule showing comparison of actual items to budget.
  - Schedule of partnership indebtedness.
  - Discussion of material changes in investments, expenses, and business of the partnership.
  - Explanation of material valuation changes.
  - Schedule of expenses of the manager.
  - An annual financial report, which may be audited or unaudited, perhaps with reconciliation of actual items to budget items.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

• A clean opinion of the partnership auditors that the annual financials conform to Generally Accepted Accounting Principles.
• Possibly an annual narrative financial report on the business and future prospects.
• Detailed computations of the preferred return.
• Detailed computations of the internal rate of return.
• Breakdown of management fees received by the manager.
• Breakdown of partnership expenses.
• Certification by the auditors that allocations and distributions are in accordance with the partnership agreement.
• Summary of calls made on partners.
• Summary of distributions.
• Schedule of partnership borrowing.
• List of political contributions made by the partnership.
• Management letter reviewing the business of the partnership.

Salviati’s partnership agreements address:

• Accounting method.
• Detailed requirements for each financial report.
• Audit requirements, if any.
• Dates by which completion of the various reports is required.
• Who receives the reports.
• When the reports must be delivered.
• What can request access to the reports.
• Minimum requirements for each report.
• Whether financial statements must be audited.
• The accounting method to be used (such as Generally Accepted Accounting Principles).
• Who prepares financial statements.
• Provisions for replacement of accountants.
Ignore Transfer Provisions.

Transfer provisions often are buried in boilerplate. This is an example of a simple transfer provision in a partnership agreement: Any attempted Transfer in violation of this Article XX will be null and void ab initio, and will not bind the Company. Unless the transferee is a Member or is admitted as a Member, a permitted Transfer will only Transfer a right to allocations and distributions under this partnership agreement.

The restrictions upon Transfer will not apply to any Transfer: (i) by a Member who is an individual to (i) his spouse, (ii) his or his spouse’s lineal descendants who are at least twenty-one (21) years of age (or a trust pursuant to clause (iv) below, if under twenty-one (21) years of age), (iii) any family limited partnership or other similar entity controlled (which for this purpose will require that this Member own more than fifty percent (50%) of the equity securities of this entity and the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of this Person, whether through the ownership of voting securities, by contract or otherwise) by this Member, (iv) a trust established solely for the benefit of this Member, his spouse and/or his or his spouse’s lineal descendants without regard to age, and (v) from any this trust to the beneficiaries of that trust;

(ii) by one Member to another Member; or

(iii) with the prior written consent of the Manager (which may be withheld, delayed or conditioned by the Manager in its sole discretion) by any Member to any other Person;

provided further, that each Permitted Transferee (other than a Person who is already a Member) pursuant to the clauses (i) through (iii) agrees in writing to become a party to this partnership agreement and to be subject to the terms and conditions of this partnership agreement. Each transferee to whom a Percentage Interest may be transferred pursuant to this Section is referred to as a “Permitted Transferee”.

Notwithstanding anything in this partnership agreement to the contrary, in addition to any other restrictions on a Transfer of a Percentage Interest, no Percentage Interest may be Transferred (a) without compliance with the Securities Act and any other applicable securities or “blue sky” laws, (b) if, in the determination of the Manager, the Transfer could result in the Company not being classified as a partnership for federal income tax purposes, (c) if, in the determination of the Manager, the Transfer could cause the Manager to become subject to the Investment Company Act of 1940, (d) if, in the determination of the Manager, the Transfer would cause a termination of the Company under Section 708(b)(1)(B)

(footnote continued on the next page)
partnership interest. Then, the transfer provisions can be a big thing. Transfer provisions can encourage or discourage transfers. Transfer provisions can sufficiently burden transfers that they can reduce the amount that a partner will receive on sale of a partnership interest. Transfer provisions also may leave the transferee with smaller rights than the rights of the transferring partner.

Antitransfer provisions may be important in ensuring that existing partners know and can work with a transferee partner. Transfer provisions may keep ownership of the partnership within the family and perhaps avoid a divorced spouse as a partner. Transfer provisions also can ensure that a transferee will have sufficient net worth or experience to be an effective partner. Transfer-related provisions can also include drag-along rights, tag-along rights, rights of first offer, rights of first negotiation, rights of first refusal, buy-sell rights, other buy-out rights, prohibitions or restrictions on sale, prohibitions and restrictions on indirect sale, and prohibitions on encumbrances.

Transfer restrictions also can further complicate estate planning, corporate restructuring, insolvency planning, borrowing, and divorce.

Transfer provisions also can address incapacity of a partner or improper behavior by a partner that may be incompatible with the continuation of his status as a partner.

of the Code that would have a material adverse effect on the Company, (e) if the Transfer, in the determination of the Manager, would violate any other law, or (f) the transferee is a minor or incompetent.

The Permitted Transferee will be admitted as a Member with respect to the Transferred Percentage Interest upon a permitted Transfer of a Percentage Interest to a Permitted Transferee. Except as provided in the immediately preceding sentence, no transferee of a Percentage Interest to any Person who is not already a Member will become a Member without –

(i) the prior written consent of the Manager, which consent may be withheld, delayed or conditioned by the Manager in the Manager’s sole discretion, and

(ii) the transferee paying to the Manager a transfer fee in cash which is sufficient, in the Manager’s sole determination, to cover all reasonable expenses incurred by the Manager in connection with the Transfer and admission of the transferee as a Member.

The restrictions on Transfer contained in this partnership agreement are an essential element in the ownership of a Percentage Interest. Upon application to any court of competent jurisdiction, the Manager or any Member will be entitled to a decree against any Person violating or about to violate this restrictions, requiring their specific performance (including those prohibiting a Transfer of all or a portion of its Percentage Interests in the Company).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Simplicio may include weak antitransfer provisions – or oppressive antitransfer provisions. Partners often care who their partners are. Partners are concerned about the identities of managing partners, money partners, and partners who may provide future property or services to the partnership. Partners may be concerned about the identity of other partners if those other partners are to provide credit enhancement. Partners may not want partnership interests transferred to undesirable characters. Partners may be concerned about the identity of other partners if those other partners are going to provide services to the partnership.

Partners may have legitimate or arguably legitimate reasons for transferring their partnership interests. For example, partnership antitransfer provisions might be used to prevent the merger or liquidation of a large corporation where the corporation is a partner. Partnership antitransfer provisions can interfere with estate planning objectives. Partnership antitransfer provisions can complicate the bankruptcy of a partner. Partnership antitransfer provisions can be used to harass or to oppress partners. Partnership antitransfer provisions may complicate the economics of a divorce. Partnership antitransfer provisions may complicate a partner bankruptcy. Partnership antitransfer provisions also may serve an important part of an asset protection plan.

Partnership antitransfer provisions also can complicate borrowing by a partner. A partner may pledge all of his assets in connection with a borrowing by the partner. This pledge may violate partnership antitransfer provisions. A partner may be unable to borrow on his own account because of partnership antitransfer or anti-encumbrance provisions.

Partnership agreements typically contain extensive restrictions on transfer of partnership interests. An important question in any case is whether these written restrictions on transfer will be enforced by a court. Salviati considers whether transfer restrictions will be enforced if a partner ends up in bankruptcy.

Salviati considers whether exceptions to transfer restrictions contain the seeds to evading transfer restrictions. Transfer restrictions often contain exceptions for certain estate planning transactions. A transfer to a trust of which the transferor is the creator and a family member is the beneficiary often is a permitted transfer. This, however, could be followed by an amendment to the trust creating another beneficiary. A transfer to a controlled corporation or partnership often is permitted as innocent. This transfer could be followed by a sale of interests in the controlled corporation or partnership. Salviati drafts permitted transfer rules carefully in order for permitted transfers not to result in the possibility of circumvention of the antitransfer provision.

Salviati is careful that his antitransfer provisions do not permit unwanted upper-tier transfers of interests in partners. These provisions require greater sensitivity. A subsidiary may not have the legal authority to prevent upper-tier trans-
fers. An antitransfer provision might require a buyout of a partnership interest if on the transfer of an indirect partnership interest.

This lists a few of many transfer restriction issues that Salviati considers in drafting each partnership agreement:

- Partners may be legitimately concerned about transferees, particularly disreputable transferees, transferees without adequate experience or capital, and competitors.
- Partners should be sensitive to both upper and lower-tier transfers and transfer restrictions.
- Partners should be sensitive to related party transfers and the potential of a transfer of a partnership interest to an entity, followed by a third party transfer of interests in that entity, being an invitation to circumventing other transfer restrictions.
- Transferees also have legitimate interests that they not be subject to risks of expropriation or other abuses.
- What are the resignation rights?
- What are the abandonment rights?
- What are tax restrictions on transfer? Do these restrictions make sense? Will opinions of counsel be required?
- What are the securities restrictions on transfer? Will opinions of counsel be required?
- Can an unadmitted transferee complain about business decisions made with the consent of the other partners?
- Do partners own a transferee the duty of good faith and fair dealing?
- Should the transfer restrictions allocate appreciation value to the transferring partner or to the continuing partners?
- What transfers are permitted without consent?
- What transfers are permitted with consent?
- What transfer restrictions apply to a marital dissolution?
- What transfer provisions apply on the death of a spouse?
- What transfer provisions apply on death of a member?
- What transfer provisions apply on bankruptcy of a member?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What transfer provisions apply on change of a trustee of a trust that is a partner?
- What transfers are not permitted?
- Can a partner make temporary, contingent or partial transfers of an interest?
- Can a transferring partner retain a 1% interest and exercise governance rights (including, without prejudice to generality, the right to bring a derivative suit) to protect the rights of his transferee?
- Can a partner pledge an interest as collateral for a loan?
- What are the rights of a lender before and after a default?
- What are the rights of a judgment creditor (of a partner) with a charging order?
- What are the rights of a judgment creditor with a charging order if the partnership fails to comply and makes distributions to the partner?
- Does a charging order apply to reasonable compensation of the partner for present or past services or reasonable payments in the ordinary course of business under a retirement plan?
- Are charging orders against an interest valid?
- Can the lender foreclose a lien on a pledged partnership interest?
- Can a partner make a gift of a life interest in a partner’s rights to distribution?
- What estate planning related transfers are permitted and under what conditions?
- Are permitted transfers consistent with estate plans?
- What transfers to related partners and affiliates are permitted and under what conditions?
- If interests are certificated, can transfers be made independent of a transfer of the certificate?
- Is a prohibited transfer effective and merely a breach of the partnership agreement or is it void?
- Are transfers subject to rights of first negotiation, rights of first refusal, buy-sell provisions, or similar rights?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Are there transfer fees? What are they? Will the partnership collect the transfer fees? How?
- Are there prohibited transferees of a partnership interest?
- What upstream transfer restrictions and rights should apply when partnership interests are owned by entities special purpose entities?
- Are there state or federal securities limitations on transfers of partnership interests?
- Are there other legal limitations on transfers of partnership interests?
- Is the tax termination of the partnership relevant to the transferability of a partnership interest?
- Is there a restriction on the creation of voluntary liens?
- Is there a restriction on the creation of involuntary liens?
- Will a transfer fee be imposed on the transferee or transferor?
- Will the transfer cause a reassessment of real property owned by the partnership?
- Will the transferee agree in writing to be bound by the partnership agreement?
- What are the securities considerations with respect to the transfer?
- Is the transferee a “qualified purchaser” under Section 2(a)(51)(A) of the Investment Company Act of 1940?
- Is the transferee an “investment company,” an “affiliated company,” or a “principal underwriter” of an “investment company” under the Investment Company Act of 1940?
- Should there be restrictions concerning transferees whose names appear on the List of Specially Designated Nationals and Blocked Persons maintained by the United States Department of Treasury Office of Foreign Asset Control?
- Should there be restrictions transfers to persons located in, or operating under a license issued by, a jurisdiction whose government has been identified by the Department of State as a sponsor of international terrorism under 22 U.S.C. 2371?
- Should there be restrictions concerning a transferee that is a “foreign shell bank” under 31 CFR 104.10(e)?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should there be restrictions on a transferee that is a person located in, or operating under a license issued by, a jurisdiction that has been designated as noncooperative with international antimony laundering principles or procedures by an intergovernmental group or organization of which the United States is a member, with which designation the United States representative to the group or organization concurs?

- Should there be restrictions on a transferee that is a person located in, or operating under a license issued by, a jurisdiction that has been designated by the Secretary of the Treasury pursuant to 31 U.S.C. 5318A as warranting special measures due to money laundering concerns?

- Will the transferee’s investment in the Company constitute an asset of any employee benefit plan subject to Part 4, Subtitle A, Title I of ERISA?

- What will be the effect of the “plan asset” rules under ERISA be?

- Will the transfer constitute a non-exempt “prohibited transaction” under Section 406 of ERISA or Code Section 4975.

- Will the transfer violate the license ownership restrictions of Section 310(b) of the Communications Act of 1934 (47 U.S.C. § 310)?

- Can the transfer cause the partnership to have more than 100 partners?

- Can the transfer cause a tax termination of the partnership?

- Should the partnership agreement restrict transfers to residents of and organizations organized under the laws of a jurisdiction that has been designated by the Secretary of the Treasury under Section 311 or 312 of the USA Patriot Act as warranting special measures regarding money laundering?

- Should the partnership agreement restrict transfers to “foreign public officials” (as used in the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions), “foreign official” (as used in the Foreign Corrupt Practices Act) and “senior foreign political figures” as defined in Section 312 of the USA Patriot Act?

- Will the transferee be subject to withholding on income or distributions?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What transfers are dependent on manager, management committee, or partner consent? What is the consent procedure? What is the basis for withholding consent?
- Is there a restriction on realization of collateral if a partnership interest is collateral for a lien?
- What are the requirements for substitution of a transferee as a substituted partner?
- What are the rights of a transferee who has not been substituted as a partner?
- When is the transfer effective?
- When is substitution of the transferee effective?
- How are distributions allocated between the transferor and transferee?
- How is the varying interests rule applied?
- What are the continuing obligations of a transferring partner?
- What are the obligations of the transferee?
- Should the partnership agreement limit upstream transfers of interests in members and indirect interests in members?
- What upstream transfers should be limited?
- How can the partnership agreement limit upstream transfers. The upstream party normally is not a signatory to the partnership agreement?
- Should the partnership agreement provide for buy-out in the event of a nonpermitted upstream transfer?
- Will a court enforce the transfer restrictions?
- Will a bankruptcy court enforce the transfer restriction?
- What happens if the transfer restriction is breached?
- Some transferability may be reasonable, such as on mergers or consolidation.
- A poorly drafted partnership agreement may become an impediment to a merger of the manager.
- The death of a partner should not breach the partnership agreement or result in a forfeiture.
The bankruptcy of a partner should not breach the partnership agreement or result in a forfeiture.

What transfers should be permitted to accomplish estate planning objectives?

Are permitted estate planning transfers consistent with estate planning documents?

What transfers should be permitted on death of a partner?

What transfers should be permitted by a partner that is a trust?

What transfers should be permitted by a partner that is a corporation?

What transfers should be permitted by a partner that is a partnership?

Potential bankruptcy of a partner can subject transfer restrictions to the jurisdiction of the bankruptcy courts. If the restrictions constitute forfeiture provisions, they may not be enforced in bankruptcy. Even if restrictions are reasonable, the bankruptcy court may treat the partnership interest as an executory contract that is subject to the jurisdictions of the trustee to accept, to reject, to accept, or to assign.

Transfers of managing interests are sensitive.

Partners should be sensitive to the situation of the party who is the transferee of a partnership interest who is not substituted as a partner.

The antitransfer provisions should consider whether a partner can pledge his partnership interest and whether and how a creditor can realize on the partnership interest in the event of a default.

The effects of antitransfer provisions on mergers and consolidations should be considered.

The effects on bankruptcy on antitransfer provisions should be considered.

Transfer provisions should address the possible admission of the transferee.

Transfer provisions should address transfer of capital account and other economics of the partnership interest.

Transfer provisions should address the effective date of transfers.
What are the property tax implications of transfers of partnership interests?

Should a partner bear the burden of increases in property taxes if property is reassessed on account of a transfer of partnership interests?

What partners should bear this burden?

Should a transferring partner bear the burden of documentary transfer tax if his assignment causes the imposition of documentary transfer tax?

What partners should bear this burden?

Should subsequent transferees share in this burden?

What should be the qualifications of a transferee?

The effects of derivative arrangements on antitransfer provisions should be considered.

Should derivative arrangements short of the transfer of a partnership interest be permitted?

Effects of an assignment of a partnership interest.

Covenant not to compete of assigning partner.

What information rights does an assigning partner have?

What information rights does a potential assignee have?

What confidential information can a potential transferor share with a potential transferee?

What are the limitations on information that a potential transferor can share with a potential transferee?

Is the assigning partner barred from discussing confidential financial information with a potential assignee?

Is the potential transferee required to sign a confidentiality agreement before receiving confidential partnership information?

Does a potential assignee have a right to inspect books and records?

Does an assignor or potential assignee have the right to inspect partnership property? Under what conditions?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Does a potential assignee have a right to talk to partnership tenants in connection with an assignment?
- Does a potential assignee have a right to see financial statements and tax returns of the partnership?
- Can an assignor cause the partnership to provide title insurance related to financing of the purchase of his partnership interest?
- Can a transferee pledge his assigned partnership interest in connection with transaction financing?
- Should proposed transfers be subject to a right of first refusal?
- Should proposed transfers be subject to a right of first negotiation?
- Should proposed transfers be subject to a buy-sell provision?
- Should the partnership agreement contain a buy-sell provision independent of proposed transfers?
- Should the partnership agreement contain drag-along rights?
- Should the partnership agreement contain tag-along rights?
- What buy-out rights should be triggered on removal, death, or disability?
- What are the rights of an estate after the death of a partner?
- Should the partnership have insurance to fund buyouts?
- What restrictions should be imposed on a transferee?
- Is the transferee admitted as a partner or may the transferee occupy the position of the holder of a profits interest?

Salviati also considers provisions that may be important to permit parties to effect or to assess a transfer of a partnership interest. This may include addressing the transferring partner’s rights to inspect books and records of the partnership and to talk to partnership employees in order to assess whether he should transfer his partnership. This also might include provisions that might be important to a lender in connection with the transfer of a partnership interest. This might include the ability to disclose partnership financial information to the lender, title insurance, etc. The transfer provision also might be designed with time periods to permit seeking financing. Salviati also considers the buyer’s need for information in structuring transfer provisions. This might include what access the buyer should have to partnership books and records and access to partnership personnel. This also might include a right of a buyer to undertake inspections of partnership prop-
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Property. This also might include a right of a transferring partner to share confidential partnership information with a potential buyer.

The partnership agreement should carefully discuss the rights and obligations rights of a dissociated partner and members who are unadmitted transferees of partnership interests.


Partnership agreements can contain any of a wide variety of buy-out rights. These buy-out rights can include buy-sell agreements, rights of first refusal, rights of first negotiation, and drag-along rights. Simplicio can compromise his partnership agreements through carelessly drafting these provisions. Buy-out rights substitute for a purchase and sale agreement.

Practitioners often insert buy-out rights without thinking much about how they will operate, whether they are fair, and whether they will work properly and quickly. Advisors should carefully consider when buy-out rights make sense and when they do not.

The partnership agreement should be clear on the events that implicate the buy-sell. These rights should be drafted with the consideration of possible lock-out periods. These rights also should be drafted with the consideration of disparities in economic power. By-out right may be triggered by –

- Disagreements and deadlocks in making management decisions, particularly major decisions. 478
- One party breaching the partnership agreement. A common breach that may trigger buy-out rights is a default in capital contributions.
- A managing partner failing to meet set management metrics.
- Removal of a managing partner.
- Malfeasance of a partner.
- Death or disability of a partner.
- Changes in control of a partner.
- A transfer of a partnership interest – or a proposed transfer of a partnership interest.
- Bankruptcy of a partner.

Query: what disputes should not trigger a buy-out right?

478
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Calls for capital contributions.
- Lack of availability of listed key personnel.
- Failure to complete construction by a stated deadline.
- Exchange of the partnership’s property.
- Incurring operating deficits.
- A proposal to liquidate the partnership.

Buy-out rights may be completely voluntary and perhaps can be exercised at any time — or perhaps after an initial stand-still period.

Salviati considers all of the provisions that might appear in a purchase and sale agreement in drafting buy-out rights. A buy-out provision drafted by Salviati might contain:

- Clarification whether the right affects all of the transferring partner’s interest in the partnership, or whether the right can affect merely a portion of the transferring partner’s interest in the partnership.
- Notice provision regarding events that can create buy-out rights.
- Clear statement concerning who can start the process and under what conditions.
- A notice mechanism that starts the process.
- A mechanism for reaching price.
- A pricing mechanism.\(^{479}\)

\(^{479}\) Pricing terms are an important aspect of buy-out arrangements. Pricing may be based on a direct determination of the value of the partnership interest or a value inferred from the fair market value of partnership assets. The value of partnership assets may be based on an orderly sale of partnership assets over a set period of time or a single sale of all partnership assets to a single buyer in a single sale. The pricing mechanism should take into account partnership liabilities, including contingent liabilities (including liabilities under pending or threatened litigation). The pricing mechanism may take into account hypothetical costs of sale, such as transfer taxes, escrow charges, brokerage, and attorneys’ fees. The pricing mechanism may also take into account hypothetical costs of winding up and liquidation of the partnership. The pricing mechanism might take into account potential increases in property taxes or other tax effects resulting from the transac- (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Rights to business information during the sale process.
- Representations and warranties, if appropriate.
- Conditions to closing, in appropriate.
- Adjustments for interim distributions.
- A time schedule for the procedure.
- Procedures for interim operations pending closing.
- Closing procedures and deliveries.
- In appropriate circumstances, provision for closing escrow.
- Apportionment of expenses.
- Mechanism for determination of the price.
- Appraisal provision, where appropriate.
- Payment terms and terms of promissory note, where appropriate.
- A mechanism to deal with currently outstanding loans to or from the partner.
- Possibly a covenant not to compete.
- Possibly a provision considering what happens if a party does not close.
- Possibly a provision for valuing partnership assets and redetermining partner capital accounts.
- Where appropriate, change in management rights during the pen-
dency of the sale.
- Covenant not to compete.
- Provisions regarding the partnership incurring liabilities after be-
ginning of the buy-out.

The pricing mechanism may take into account penalties related to prepay-
ment of partnership indebtedness. There may be confusion if the partnership
agreement merely refers to the “fair market value” of a partnership interest or of
partnership assets without more clarification. The pricing mechanism may consid-
er discounts imposed on the value of the partnership interest for marketability,
lack of control, minority interest, and a number of other factors.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- An agreement not to sell the partnership property during the buy-out period.
- Standstill of exercise of other buy-out rights once a buy-out right has been exercised.
- Remedies on default.
- Standstill periods to permit a party to obtain financing.
- Provisions addressing a lender’s concerns.
- Provisions regarding title insurance.
- Provisions regarding prorations.
- Provisions regarding interim operations.
- Provisions regarding interim distributions.
- Provisions regarding a party’s right to inspect books and records, access to other financial information, access to partnership personnel, and rights to inspect the partnership property.
- Provisions regarding a lender’s access to confidential partnership information.
- Tenant estoppels.
- Provisions regarding warranties and representations. Who do they come from?

The draftsman should consider the effects of different rights to access to business information. The draftsman should consider whether values are determined based on underlying asset values and then converted into a price for a partnership interest – and how. The draftsman should consider the effects of time between initiation of the buy-out provision and closing.

The partnership agreement may contain a right of first negotiation. While these rights of first negotiation are varied, the overriding principle is that a partner who wishes to sell his partnership interest first must offer the partnership interest to the other partners or to the partnership. The partnership agreement contains a procedure for negotiating or otherwise reaching a price. The partner is free to sell the partnership interest at a price no less than the price reached with the partnership or the partners if the partners do not agree on a deal.

A right of first refusal drafted by Salviati might contain:

- The right of first refusal typically starts with a *bona fide* third party offer.
• The right of first refusal may require a proposed transfer of the partner’s entire partnership interest and not merely a portion of that partnership interest.

• The right of first refusal provision addresses what happens if consideration includes property other than cash. The consideration provided may be unique. Property included as consideration should be valued in terms of cash value.

• The right of first refusal may limit the third party offer to offers with payments exclusively made in cash, cash equivalents, and similar consideration that is easily valued.

• The right of first refusal deals with the possibility that payments will be made in the future.

• The right of first refusal may limit third party offers to offers that are made for all of the selling partner’s interest.

• The right of first refusal details the requirements of the offer notice. Among other things, this notice typically includes who is the third party buyer, the price, the closing date, and other material terms and conditions.

• The right of first refusal clarifies who has the right to buy and who, if anyone, has a backup right to buy if the first party does not elect to buy the offered interest.

• The right of first refusal normally provides a period during which the right of first refusal offer remains open.

• The right of first refusal provides for a mechanism of how the right of first refusal offer is accepted.

• The right of first refusal indicates the terms of purchase if the right is exercised.

• The right of first refusal may contain a provision of allocation of the purchased interest among multiple purchasers.

• The right of first refusal provides a closing procedure.

• The right of first refusal provides a payment procedure.

• The right of first refusal addresses conditions, warranties and representations. Those in the original offer may not be appropriate.

• The right of first refusal usually permits transfer of the partnership interest if the right of first refusal option is not exercised.
A fundamental question is whether the right of first refusal notice should set forth detailed provisions that will control the sale under the buy-sale or whether detailed sale procedures should be set forth in the partnership agreement. Many advisors believe that the transaction should close under provisions set forth in the partnership agreement and that the purchasers under the buy-sale not be constrained to terms offered to the third party (other than price). The purchase and sale agreement may contain provisions that are appropriate for a third party agreement but that may be unnecessary or inappropriate for a deal with the partnership or the partners.

A buy-sell provision that Salviati drafts as part of his partnership agreements might contain provisions addressing these issues:

- The buy-sell provision contains detailed procedures, including, without prejudice to generality, timing, for the buy-sell procedure.
- Should the partnership agreement provide a lock-out period during which the buy-sell provision cannot be exercised? This lock-out period, for example, might include the construction period for real property and the period prior to achieving stabilized rental of a project.
- On what events can the buy-sell provision be initiated?
- Who may initiate the buy-sell procedure?
- How is the buy-sell procedure initiated?
- What is the notice requirement for the buy-sell procedure?
- What must the initiating notice contain?
- Should the buy-sell provision contain detailed terms of purchase?
- The buy-sell provision typically requires an all-cash purchase – although the buy-sell provision may provide for certain payments to be deferred.
- If the buy-sell does not limit purchase consideration to cash, the buy-sell should have a means to convert the value of property into a cash price?
- Among other things, the buy-sell notice normally must contain a price for something. That price may be the price of the interest of the partner giving notice, or it may be a gross or net value of partnership assets.
- The buy-sell provision contains a means of translating consideration for the interest of the initiating partner into consideration for
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

the interests of the other partners. This is important if the partnership is not a simple, straight percentage partnership.

- Is there a deposit requirement at the time of initiation of the buy-sell procedure?
- Is there provision for ensuring the other parties of the availability of funds to make the purchase under the buy-sell provision?
- Can the buy-sell procedure be initiated with respect to less than all of the interests owned by a partner?
- Should the partnership agreement contain provisions for financing?
- Should the buy-sell procedure provide adequate time for a party to obtain financing? What period is reasonable?
- If the notice can provide for detailed terms of purchase, might those terms be used to make the buy-sell provision impractical or to give one party an unfair advantage?
- Who is the purchaser when the buy-sell provision is initiated?
- The buy-sell provision sets forth the various time periods that apply for the buy-sell procedure.
- The buy-sell procedure details a closing procedure.
- In appropriate circumstances, the buy-sell procedure provides for a closing escrow.
- The buy-sell provision addresses warranties and representations.
- The buy-sell provision addresses interim distributions between notice of exercise and closing.
- The buy-sell provision addresses allocation of transaction costs.
- The buy-sell provision addresses treatment of outstanding partner loans, guarantees, and other obligations.
- The buy-sell provision may provide for a covenant not to compete.

The partnership agreement may contain tag-along and drag-along rights. Salviati’s partnership agreements detail the complete procedures.

The partnership agreement also may contain conditions for a nonmanaging partner to force a sale of partnership property.
47. Ignore Other Laws – State and Otherwise.

Simplicio easily can get into trouble in drafting a partnership agreement if he fails to consider all of the applicable laws.\textsuperscript{480} Considering specialized laws is important with a partnership agreement that performs a specialized function (such as a partnership agreement for a rock band or a motion picture or Broadway production). Take into account other laws and general agreements (such as labor or guild agreements) that may impact on the partnership agreement and its business.\textsuperscript{481}


Tax return provisions in the partnership agreement typically are routine and do not receive much considerations. One thing is certain: the partnership must be able to file its tax returns on a timely basis.

Being tax matters partner has nothing to do with tax returns as a matter of federal income tax law. The tax matters partner occupies an informational and organizational function in connection with TEFRA audits. The tax matters partner does not have any special responsibilities in connection with partnership tax returns.

\textsuperscript{480} The draftsman naturally will not be able to consider all possibly applicable laws. The draftsman should consider those laws whose application would be identified by a reasonable draftsman who is similarly situated.

\textsuperscript{481} These laws (and regulations) may include (among others), in appropriate situations: agriculture law; alcoholic and beverage control law; antitrust law; banking law; bankruptcy law; business regulatory law; commerce and trade law; commercial law; communications law; commercial law; conservation law; corporate law; criminal law; employment law, energy law; entertainment law; environmental law; fiduciary law; financial law; food and drug law; international and foreign laws (including, without prejudice to generality, laws of foreign states and foreign nations); insurance law; labor law; marital property and family law; money laundering law; patent, copyright, and trademark law; procedural law concerning arbitration and other alternative dispute resolution; professional regulatory law; public health law; public resources law; public utilities law; property law; real estate law; state and federal securities law; state law concerning liquidated damage provisions and other agreed remedies; tax law; transportation, trade, shipping, vehicle, and navigation law; usury law; and water law.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Someone should have responsibility to prepare and to review partnership tax returns. Other partners may retain the right to review and to comments on the partnership tax returns. A well-drafted partnership agreement may contain provisions setting forth deadlines for providing copies of tax returns to partners, for partners to review and to comment on the returns, for discussions regarding tax return reporting, and finally for the partnership to file its returns. These other partners should not have the ability to prevent the partnership from filing its tax returns on a timely basis.

Salviati’s partnership agreements clarify:

- Who has responsibility to prepare partnership tax returns?
- Who has responsibility to make partnership elections?
- Does the partner with responsibility for preparing tax returns have an obligation to submit the returns to other partners for review?
- What is the tax return review procedure?
- How much time do the other partners have to review draft tax returns?
- What is the tax return dispute procedure?
- Are partners required to report on their personal tax returns in accordance with the partnership tax return?
- Who makes the ultimate decisions regarding tax return reporting?

49. Ignore Tax Audit Issues.

The tax laws may subject partnerships to tax audits at the partnership level. The TEFRA audit rules make an exception for any partnership having ten or fewer partners, each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. The rules treat husband and wife (and their estates) as one partner for this purpose. The TEFRA audit rules exempt these small partnerships from the consolidated audit rules unless these small partnerships make a specific election. Partnerships otherwise are audited at the partnership level in a consolidated proceeding, often referred to as a “TEFRA audit.”
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Item) is generally determined at the partnership level for partnerships subject to TEFRA audits. 482

A key person in a TEFRA audit is the “tax matters partner.” The tax matters partner coordinates the partnership audit efforts for the partnership and has various notice and filing responsibilities. The responsibilities of the tax matters partner do not extend beyond the audit of the partnership and resolution of tax disputes. 483 The tax matters partner does not have any special obligation to file

482 I.R.C. § 6231(a)(7) (“(7) Tax matters partner. The tax matters partner of any partnership is – (A) the general partner designated as the tax matters partner as provided in regulations, or (B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing). If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence, notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.”).

483 See Treas. Reg. § 301.6223(g)-1 (“Responsibilities of the tax matters partner. (a) Notices described in section 6223(a). (1) Notice of beginning of proceeding. Except as otherwise provided in section 301.6223(a)-2, the tax matters partner shall, within 75 days after the Internal Revenue Service mails the notice specified in section 6223(a)(1), forward a copy of that notice to each partner not entitled to notice from the Internal Revenue Service under section 6223. See section 301.6230(e)-1 for information to be furnished to the Internal Revenue Service. (2) Notice of final partnership administrative adjustment. The tax matters partner shall, within 60 days after the Internal Revenue Service mails the notice specified in section 6223(a)(2), forward a copy of that notice to each partner not entitled to notice from the Internal Revenue Service under section 6223. (3) Requirement inapplicable in certain cases. The tax matters partner is not required to send notice to a partner if – (i) Before the expiration of the applicable 75-day or 60-day period the partnership items of that partner have become nonpartnership items (for example, by settlement); (ii) That partner is an indirect partner and has not been identified to the tax matters partner at least 30 days before the tax matters partner is required to send such notice; (iii) That partner is treated as a partner solely by virtue of section 301.6231(a)(2)-1; (iv) That partner was a member of a notice group as of the date on which the notice was mailed to the tax matters partner (see section 301.6223(b)-1(c)(4) for the date on which a partner becomes a member of a notice group); (v) The notice has already been provided to that partner

(footnote continued on the next page)
partnership tax returns or to make partnership elections. Salviati’s partnership agreements appoint a qualifying partner as the tax matters partner. Salviati is careful to designate a qualifying partner as tax matters partner.

TEFRA audit provisions in partnership agreements typically are deficient. Some small partnerships that do not elect the TEFRA audit rules are not subject to TEFRA audit rules. Extensive TEFRA audit provisions are not useful for a partnership that is not subject to TEFRA audit rules. If the partnership is subject to
TEFRA audit rules, the audit provisions in Salviati’s partnership agreements provide a workable structure for running the audit. This structure includes:

- Selection of the tax matters partner.
- Removal of the tax matters partner.
- Replacement of the tax matters partner.
- Responsibilities of the tax matters partner.
- Qualifications of the tax matters partner.
- Compensation of the tax matters partner.
- Provisions for funding the audit (including, without prejudice to generality, funding after the dissolution of the partnership).
- Selection of accountants for the tax audit.
- Selection of attorneys for the tax audit.
- Extension of statute of limitations.
- Authority to compromise the partnership audit.
- Authority to take the dispute to court and to select forum.
- Partner rights to participate in partnership audits.
- Information requirements in notifying partners of the progress of partnership audits.

50. **Dispute Resolution.**

Many ways are available to the partners to resolve disputes among partners or between the partners and the partnership. These methods consider the preferences and prejudices of the partners and the nature of dispute that the parties anticipate. Dispute resolution procedures may provide speed, cost savings, informality, flexibility, and confidentiality. Skeptics, however, may feel that dispute resolution procedures will fail to deliver on all of these promises.

Simplicio is economical with the time that he spends on dispute resolution provisions. He merely uses whatever provision is in the old form. This often results in dispute resolution provisions that do not meet client needs, provisions that are ambiguous, and provisions that leave gaps. This often produces disputes over the dispute resolution provisions.
Dispute resolution often is left until the end of contract negotiations. Salviati is careful to raise the details of dispute resolution in the first draft of his term sheet.

Salviati considers:

- Confidentiality and privacy can be important considerations in selecting a dispute resolution procedure.
- Efficiency and speed can be important in selecting a dispute resolution procedure.
- Cost and efficiency can be important in selecting a dispute resolution procedure.
- Appealability can be important in selecting a dispute resolution procedure.

Some investors feel that mediation is an important step in resolving disputes. Other investors disfavor mediation.

Some investors prefer arbitration. Others dislike arbitration.
Some investors prefer to deal with disputes through the courts. Other investors prefer to stay out of court.

Some investors prefer to deal with disputes through buy-sell provision or similar buyout arrangements.

Salviati considers these issues in drafting:

- What matters are subject to the dispute resolution procedure?[^484]
- What dispute resolution procedure should be available to the parties?
- What are the details of the dispute resolution procedures?
- Is the dispute resolution procedure binding or nonbinding?
- Should appeal be available from the results of the dispute resolution procedure?

[^484]: A clause might provide something like this: “Any controversy or claim arising out of or relating to this Partnership Agreement, the partnership, the business of the partnership, or matters involving the Partners relating to the partnership, or the breach of any agreement among the parties related to the partnership, shall be determined by ________.”
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Who determines whether a matter is subject to the dispute resolution procedure? Does the fact finder determine his authority to hear the dispute? Does the fact finder determine the existence and the validity of the partnership agreement and other agreements? Does a decision by the fact finder that the partnership agreement is null and void render invalid the dispute resolution clause?

- What limitations are there on a party to object to the jurisdiction of the fact finder or the ability of the fact finder to hear the claim or counterclaims?

- Does using the same dispute resolution procedure for all disputes under the partnership agreement make sense – or should different mechanisms be used for different issues (e.g., an expedited mechanism for certain disputes)?

- Will dispute resolution require negotiation or optional or mandatory mediation prior to more formal proceedings (a “step clause”)?

- What are the appropriate periods for the steps if the partnership agreement contains a step clause?

- Does a step clause result in unreasonable delay?

- Should the partnership agreement provide for negotiation or mediation concurrent with other dispute resolution?

- Who can initiate the dispute resolution procedure?

- How do the parties initiate the dispute resolution procedure? What is the initiation procedure?

- What are the timing requirements for initiating the dispute resolution procedure?

- What are the other timing requirements for the dispute resolution provision?

- What provisions are there for changing claims during the dispute resolution proceedings?

- Should the partnership agreement provide for a written statement of defense? When is it required to be submitted? When?

- Is there provision for counterclaims? What procedure should be followed?

- Is a failure to answer the claims with a specified period a deemed admission or a deemed denial?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should the partnership agreement provide for interim or emergency relief?
- Where will the proceedings be held?\(^{485}\)
- Should there be provision for deposits for fact finding procedure expenses prior to an award?
- What are the requirements for statement of the claim in the initiation notice? The initiation notice might include, without prejudice to generality, a copy of the provisions of the partnership agreement regarding dispute resolution procedure, the names, regular mail addresses, email addresses, and telephone numbers of all parties and their representatives, a brief chronology of the facts and a statement of the principal factual issues in dispute, a description of the claims with sufficient detail to make the circumstances of the dispute clear to the fact finder, a brief statement, without extended legal argument, of the disputed points of law, including, without prejudice to generality, reference to specific statutes and decisions, and relief sought, including the amount of damages sought and a description of the bases on which damages are calculated, whether the dispute is subject to an expedited dispute resolution procedure, any specific qualifications of the fact finder, and the hearing locale requested for proceedings.
- How is the fact finder in the dispute resolution proceeding appointed? Will the parties rely on a list or procedure from a dispute resolution organization? Do the parties agree on a specific fact finder in advance? What happens if he becomes unavailable?
- Does a potential fact finder have an obligation of disclosure of circumstances likely to create doubt about the potential fact finder’s impartiality or independence?
- What is the procedure for seeking to disqualify a fact finder? What are the grounds for seeking to disqualify a fact finder (e.g., partiality, lack of independence, inability or unwillingness to perform duties with diligence and good faith, and other grounds provided by law)?

\(^{485}\) The choice should consider where the parties are located, where counsel is located, availability of witnesses, availability of facilities and indirect facilities (such as hotels, etc.), availability of the fact finder, and local procedural law.
• If there is more than one fact finder, what is the procedure for appointing a chairman of the fact finders? What is the period of time for appointing a chairman?
• If the parties are nationals of different countries, does a party have a right to object to a national of the country of one of the other parties as fact finder on the basis of nationality?
• What are the required qualifications of the fact finder in the dispute resolution proceeding? Is an area of expertise required? Are there limitations on who may be the fact finder in the dispute resolution proceeding? Does the fact finder have the authority to determine that he meets the requirements of the partnership agreement?
• What provision should the partnership agreement make for compensation of the fact finder?
• What happens if there are disagreements concerning the fact finder’s compensation?
• Is there a requirement that the fact finder in the dispute resolution proceeding be impartial and independent?
• How many fact finders in the dispute resolution proceeding will there be?
• What are the duties and responsibilities of the fact finder in the dispute resolution proceeding?
• What are the restrictions on ex parte communications with the fact finder?
• What happens if a fact finder becomes unwilling or unable to perform his duties? How are vacancies filled?
• Will a meeting of all fact finders (when there are multiple fact finders) in the dispute resolution proceedings be required for discovery disputes – or can a single fact finder in the dispute resolution proceeding act alone?
• What provisions do the parties require concerning conflicts of interest of the fact finder in the dispute resolution proceeding? Who determines whether a conflict of interest exists?
• Does the fact finder have the power to make determinations regarding admissibility, relevance and materiality?
• Does the fact finder have the power to exclude cumulative evidence?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- May the fact finder accept evidence of witnesses by declaration or affidavit?
- What power does the fact finder have to make inspections?
- What interim relief may the fact finder award?
- Is the fact finder required to respect privilege? If so, which laws of privilege will the fact finder apply?
- What is the permissible scope of the fact finder’s award (e.g., damages, equitable relief, interest, attorneys’ fees)?
- Is a consent award permissible if the parties reach agreement concerning the award?
- How does the fact finder present the notice of the award to the parties?
- What provisions are available for modification of the fact finder’s award (e.g., for computational, clerical and typographical errors)?
- What happens if the fact finder in the dispute resolution proceeding fails to adhere to the specified periods? Will the award be placed in jeopardy?
- What are the powers of the fact finder in the dispute resolution proceeding?
- What manners of inquiry are available for the fact finder in the dispute resolution proceeding to take evidence?
- Is it advisable to restrict the proceedings in the dispute resolution? Will this interfere with management of the proceedings by the fact finder in the dispute resolution proceedings?
- Is there indemnification of the fact finder?
- What discovery is available (depositions, form interrogatories, special interrogatories, requests for admissions, demand for production of documents or inspection of records, demand for physical examination, request for admissions, subpoena, request for statement of damages, etc.) in the procedures?
- Should there be a limit on number of interrogatories per party?
- Should there be a limit on requests for admissions?
- Should there be a limitation on number of depositions per party?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should there be a limitation on number of hours per deposition – or total dispositional hours?
- Should different discovery limits apply depending on the size of the dispute?
- Should there be limitation on document requests?
- Should there be limitations placed on discovery of electronically stored information (e.g., only from sources used in the ordinary course of business and exclusive of metadata)?
- Should a proportionality standard (e.g., Federal Rules of Civil Procedure, Rule 26(b)(2)(C) and 26(g)(1)(B)(iii)) apply to electronically stored information?
- Should there be an electronically stored information preservation plan?
- Should the parties be required to use preservation letters regarding preservation obligations regarding electronically stored information?
- Is there a requirement to meet and confer concerning scope of preservation efforts for electronically stored information?
- What requirements should be imposed regarding electronically stored information from sources that are not reasonably accessible (e.g., backup media created a certain period before the institution of the proceedings, digital voicemail, instant messaging, automatically saved versions of documents)?
- What provisions should there be regarding opportunities to reduce the costs and to increase the efficiency of discovery?
- What procedures should there be concerning narrowing of issues and expediting presentation of evidence?
- Should there be provisions concerning electronically stored information liaisons?
- Should the provisions regard interdiction of document destruction programs (such as erasures of e-mails, voicemails, and other electronically-recorded material).
- What provisions should there be concerning phased discovery?
- Are there limitations on discovery?
- What provisions should there be regarding protective orders?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

• How is scheduling handled?
• What matters can be handled by conference telephone?
• Should there be provision for a preliminary hearing?
• When are stenographic records of proceedings required? Who pays the cost of the stenographer?
• What provisions should there be concerning interpreters? Who pays the costs of interpreters?
• What provision should there be concerning postponements of hearings?
• What happens if a party or his representatives is absent from a hearing?
• May an award be made on the basis of a default?
• What happens at the evidentiary hearing?
• What evidence may be presented at the evidentiary hearing?
• Should there be special provisions regarding exchange of information, production of documents and other information, and identification of witnesses?
• Should there be provisions regarding exchange of exhibits to be presented?
• Do the parties wish to limit the timing of the dispute resolution?
• What are the rules for conducting evidentiary sessions?
• Is there a requirement that an award will be rendered within a specified period of time?
• Is there a requirement for a written award?
• Is the award required to be a reasoned award?
• What procedures are available if a party fails to participate?
• Should there be a pre-hearing information exchange? What is involved in that pre-hearing information exchange?
• Will the dispute resolution procedure be private?
• Are limitations appropriate for dispositive motions?
• Should the resolution of disputes be based on submission of documents and no in-person or oral hearing?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Will there be oral arguments or are parties limited to written arguments?
- Will the fact finder in the dispute resolution proceedings hear testimony?
- Are electronic filings and service permitted?
- Are written transcripts of proceedings required?
- What other procedural concerns should the partnership agreement address?
- Who pays what transactional expenses of the dispute resolution?
- Does the fact finder in the dispute resolution proceedings have the power to allocate costs of the proceedings? Does this include reasonable attorneys’ fees of the prevailing party? What is the definition of the “prevailing party” for this purpose?
- What expenses are included in the award?
- What remedies are available? What remedies are excluded? Should remedies include punitive or exemplary damages? Should the remedy include consequential damages? Is the remedy limited to a monetary award?
- What substantive laws does the fact finder apply?
- What rules of evidence does the fact finder apply?
- What procedural rules does the fact finder apply?
- Where will the dispute resolution procedure be conducted?
- Can the fact finder employ experts?
- What damages is the fact finder able to award?
- Can the fact finder award punitive damages?
- How will equitable relief be obtained?
- Will records of the dispute resolution procedure, etc. be public?
- What is the governing state law?
- Should the dispute resolution be subject to a confidentiality clause?
- Is there any way to control the confidentiality with respect to witnesses?
- Are dispute resolution proceedings to be close to outsiders?
51. **Indemnification.**

Managers and others dealing with partnerships often wish to be indemnified from liability with respect to partnership obligations. Indemnifications are often included as part of the “boilerplate” in agreements. Investors often pay little attention to indemnifications until a need for indemnification arises. Then, parties take the indemnification provisions seriously. Indemnification provisions often are clumsy concerning who is indemnified. Indemnification provisions often are unclear on precisely what is indemnified. Indemnification provisions may indemnify matters that, on reflection, the partnership might prefer not to indemnify. For example, the partnership may prefer not to indemnify a manager who faces criminal proceedings for theft from the partnership. Indemnification provisions often are ambiguous on when indemnification payments are made. Indemnification provisions often fail to set forth efficient indemnification procedures.

Typical problems in indemnification procedures are indemnifications of people who should not be indemnified, broader indemnities than appropriate, and weak indemnification procedures. Some partnership agreements are unclear concerning how indemnifications are to be funded.

Some of the issues that Salviati considers in drafting indemnification procedures include:

- Does the indemnification agreement encourage, or fail to discourage, improper behavior?
- Do aspects of the indemnification agreement violate public policy?
- Does the indemnity agreement realistically assign responsibility for bearing losses?
- Who is entitled to indemnification and under what circumstances?
- Should agents, employees, *etc.* be indemnified?
- Should accountants, attorneys, *etc.* be indemnified?
- Should the indemnification extend to employees, agents, and professionals employed by the partnership?
- What matters are indemnified matters?
- What losses are parties indemnified from (e.g., losses, actions, liabilities, damages, expenses, reasonable attorneys’ fees, and court costs)?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What should be excluded from the indemnification (e.g., costs of criminal defense, fines and penalties, punitive damages, and consequential damages)?
- Is there a dollar limit on the indemnified amount?
- Should parties be indemnified from liabilities where they already are protected by liability or other insurance? Should there be an offset for insurance recoveries? Should there be an offset for insured amounts?
- Does the indemnification extend to malpractice liabilities?
- Does the indemnification extend to negligence?
- Does the indemnification extend to gross negligence?
- Does the indemnification extend to intentional acts?
- Does the indemnification extend to criminal acts? What criminal acts?
- Does the indemnification extend to defamation?
- Does the indemnification extend to breaches of the warranty of authority in connection with signing unauthorized instruments?
- Does the indemnification include costs of investigation?
- Does the indemnification include actions by the partnership against the indemnified person?
- Does indemnification extend to breaches of the partnership agreement?
- Does the indemnification extend to fiduciary breaches?
- Does the indemnification extend to good faith breaches?
- Does the indemnification extend to negligent breaches?
- Does the indemnification extend to intentional breaches?
- Is the indemnification limited to acts reasonably believed to be within the scope of duties of the indemnified persons?
- Does the indemnification include an indemnification against acts from which the indemnified person reasonably sought to obtain an improper personal benefit?
- Does advice of counsel affect the indemnification?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Does the indemnification include an indemnification against acts that are not undertaken in good faith?
- Does the indemnification include an indemnification from results of acts that are illegal?
- Does indemnification include consequential damages?
- What are the indemnification procedures?
- What cooperation is required?
- What are the effects of insurance coverage?
- Who bears the cost of the indemnification?
- What are the detailed indemnification procedures?
- Requirements for notice of indemnification, who receives the notice and when?
- Are there conditions to indemnification (e.g., prompt written notice by indemnified party to indemnifying party of any claim, action or demand for which indemnity is claimed; tender of control of defense and settlement by indemnifying party, reasonable cooperation by indemnified party in defense as indemnifying party may request)?
- Who is obligated to defend actions?
- Should the partnership agreement provide for participation in defense by the other party?
- Is there provision for tender of defense?
- When are expenses and other indemnified amounts paid under the indemnification provision?
- Are indemnification payments made in advance?
- Are parties indemnified from breaches of the partnership agreement, from fiduciary breaches, and other cause events?
- Does indemnification include costs and expenses of counsel?
- What are the informational requirements?
- What is the detailed indemnification procedure?
- Who determines the indemnification payments?
- What are requirements for an indemnification notice that starts the indemnification procedure?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- What are the effects of failure to give a timely indemnification notice?
- Who selects counsel?
- Can the indemnified person select the most expensive counsel available?
- Can the indemnifying person select the least expensive counsel in town?
- Is there incentive to conduct the defense inexpensively?
- Who controls defense of indemnified matters?
- Are there rights of participation?
- Who controls compromise or settlement of claims?
- Does the other party have input into compromise or settlement?
- Is there provision for tender and assumption of defense by the indemnifying party?
- Is there a cooperation requirement?
- Who provides current funding of defense?
- Who has right to settle or compromise?
- Who negotiates settlements?
- What is the settlement procedure?
- Does the partnership retain the right to approve settlements?
- When do indemnification payments stop in the case of a criminal matter or matter that arguably may not be indemnified?
- Is there a clawback if damages are later determined not to qualify as indemnified?
- Is there a procedure to determine whether amounts are indemnified?
- Are consequential damages indemnified?
- Is there an offset for insured amounts?
- Can an indemnified person seek compensation for its cooperation?
- Is the indemnified party compensated for time lost in defending an action? At what rate?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What are the requirements to keep parties informed of the progress of the defense?
- When are indemnification amounts paid?
- What happens if indemnification payments are not paid on a timely basis?
- What are the survival provisions for the indemnification?
- Do members have personal liability for indemnification payments?
- Is there partner clawback for indemnification expenses?
- What is the period of limitations on personal liability for indemnification payments?
- Is there a right of offset in making indemnification payments?
- Is there provision for advancement of expenses?
- Is there a provision for clawback if expenses are determined not to be indemnified?
- Is there provision for dispute of expenses?
- How are disputed concerning indemnification handled? settle

Simplicio may rely on whatever his form partnership agreement provides. Simplicio can rely on his form agreement and on his errors and omissions insurance policy.

52. Needs of Special Partners.

The partnership agreement may have clauses to protect the interests of special partners. These provisions typically favor some partners and disfavor the interests of other partners. These provisions may or may not protect the partners that they are designed to protect. These provisions may constitute a heavy burden on the business of the partnership.

Some common provisions that Salviati considers including when a partner is a tax qualified pension plan or a real estate investment trust are these:

- A requirement that the partnership will make minimum distributions to the real estate investment trust partner each year equal to the real estate investment trust’s share of taxable income of the partnership.
- Provisions addressing the “plan asset rules” regarding tax qualified pension funds.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- An obligation to conduct business of the partnership in such manner as is necessary to permit the real estate investment trust to meet the income and asset tests of Section 856, particularly the income tests under Section 856(c)(2) and (c)(3) and the asset tests of Section 856(c)(4).\(^{486}\)

- A restriction that the partnership rents will qualify as “rents from real property” or other qualifying income under Section 856(c)(2).

- A requirement that the partnership will not take any other action that would cause the real estate investment trust partner to fail to meet the real estate investment trust qualification requirements.

- The partnership will not perform or provide any services to tenants that would cause the partnership to derive “impermissible tenant service income” within the meaning of Section 857(d)(7).

- A requirement that any services that might result in “impermissible tenant service income” must be provided by a “taxable real estate investment trust subsidiary” of the real estate investment trust partner or by an “independent contractor” from whom neither the partnership nor the real estate investment trust derives any income, directly or indirectly.

- The partnership will not derive any income from any lease that would cause the partnership to derive payments received under a lease that do not qualify as “rents from real property” if the partnership were taxed as a real estate investment trust.

- The partnership will not be party to any lease of real property, under which any amount received or accrued by the partnership, the determination of which is based in whole or in part on the income or profits derived by any person from the property within the meaning of Section 856(d)(2)(A).

- The partnership will not hold securities possessing more than ten percent of the total voting power of the outstanding securities of any one issuer, or hold securities having a value of more than ten percent of the total value of the outstanding securities of any one issuer, all within the meaning of Section 856(c)(4)(B)(iii).

- Provisions that address the 15% rent requirement for rental of personal property under Section 856(d)(1)(C).

\(^{486}\)
A provision that a decision on any matter or action of the partnership will be a Major Decision and will require the prior written consent of the real estate investment trust partner if, in the reasonable determination of the real estate investment trust partner: (i) the decision would have an adverse effect on the real estate investment trust partner’s status as a “real estate investment trust” under Sections 856 through 860 or (ii) reasonably could be expected to result in the imposition on the real estate investment trust partner of tax under Section 857(b)(5), (6) or (7).

The partnership will not have any income from “redetermined rents,” “redetermined deductions,” or “excess interest,” as those terms are used in Section 857(b)(7).

The partnership will not enter into any agreement or lease (with respect to any property) that (i) contains any provision for the payment of rental or other sums based in whole or in part on the income or profits (other than gross receipts) derived by the other contracting party from the premises as determined under Section 856(b)(3) or (ii) provides for rents that fail to qualify as “rents from real property” under Section 856(d).

The partnership will not enter into any agreement or lease relating to any property under or in connection with which the rent or other payment attributable to personal property for any year exceeds fifteen percent (15%) of the total rents received under or in connection with such agreement or lease as determined under Section 856(d)(1)(C).

The partnership will not provide any services that are primarily for the convenience of the tenants of any property and are other than services usually or customarily rendered in connection with the rental for occupancy only of office space, as described in Treasury Regulations Section 1.856-4(b)(1).

The partnership will not sell or otherwise dispose of the property in any manner that would cause the property to be treated as property held primarily for sale to customers in the ordinary course of the partnership’s trade or business as determined under Section 1221(a) or Section 857(b)(6).

The partnership will not enter into any lease that provides for the partnership to provide to the tenant services other than services customarily furnished or rendered in connection with the rental of real property, whether or not such charges are separately stated, as determined under Section 856(d)(1)(B). Services furnished or ren-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

dered, or management or operation provided, through an “independent contractor” from whom the real estate investment trust partner or the partnership itself does not derive or receive any income or through a taxable real estate investment trust subsidiary of the real estate investment trust partner will not be treated as furnished, rendered, or provided by the real estate investment trust partner or the partnership, as determined under Section 856(b)(7)(C)(i).

- The partnership will not enter into any lease or activity that results in the partnership receiving “impermissible tenant service income,” as determined under Section 856(d)(7).

- The partnership will not receive or accrue directly or indirectly from any person if the partnership or the real estate investment trust partner owns, directly or indirectly (i) in the case of any person that is a corporation, stock of such person possessing 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock of such person; or (ii) in the case of any person that is not a corporation, an interest of 10 percent or more in the assets or net profits of such person, all as determined under Section 856(d)(2)(B).

- Restriction that the partnership will not engage in any “prohibited transaction” as defined in Section 857(b)(6).

- Restriction that the partnership will not hold any property described in Section 1221(a)(1) other than foreclosure property, as determined under Section 856(e).

- Restriction that the partnership will not incur any redetermined rents, redetermined deductions, or excess interest subject to tax under Section 856(b)(7).

- Restriction that the partnership may not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer.

- Restriction that the partnership may not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer.

- Provision that the partnership; take any action requested by the real estate investment trust partner that is necessary or advisable in order to, (i) protect the ability of the real estate investment trust partner to continue to qualify as a “real estate investment trust” (under
Part II of Subchapter M of Chapter 1), or (ii) permit the real estate investment trust partner to minimize any taxes otherwise imposed on the real estate investment trust partner under Section 857 (taxation of real estate investment trusts) or Section 4981 (tax on undistributed income), is expressly authorized under the partnership agreement.

- A requirement for the partnership to make distributions necessary to permit a real estate investment trust to make required distributions.

- A requirement for the partnership to avoid “prohibited transactions” as the term is used in Section 856(b)(6).

- Restrictions related to unrelated business taxable income under Section 514.

- A requirement for the partnership to avoid unrelated business income.

- A provision that a decision on any matter or action of the partnership will be a Major Decision if it would (i) have an adverse effect on the tax exempt status of the tax-exempt partner, (ii) create a reasonable possibility that any non-de minimis income of the partnership allocated to the tax-exempt partner will be taxed as unrelated business taxable income, or (iii) result in a non-exempt “prohibited transaction” under ERISA or the Code.

- Restriction on any agreement or lease (with respect to any property) that provides for the payment of rental or other sums based in whole or in part on the income or profits (other than gross receipts) as determined under Section 512(b)(3)(B)(ii).

- Restrictions on any lease or agreement providing for rent or other payment attributable to personal property for any year exceeding 15% of the total real property rents received under the lease or agreement as determined under Section 512(b)(3)(A)(ii).

- Restrictions on the partnership providing any services that are primarily for the convenience of the tenants of any property and are other than services usually or customarily rendered in connection with the rental for occupancy only of office space, as described in Treasury Regulations Section 1.512(b)-1(c)(5).

- Restriction that the partnership will not sell or otherwise dispose of the property in any manner that would cause the property to be treated as property held primarily for sale to customers in the ordi-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

nary course of the partnership’s trade or business as determined under Section 512(b)(5)(A) or (B).

- Restriction on the partnership entering any lease with (i) any partner, (ii) the seller that sold the applicable property or any person who bears a relationship to such person described in Section 267(b) or 707(b), or (iii) any person who is a “party in interest” or “disqualified person” within the meaning of Section 514(c)(9)(B)(iv)(I) or (II) with respect to a qualified pension partner.

- Requirement that any lessee provide a representation and covenant that the tenant is not, and will not be at any time during the term of the lease, the seller of the property or related to this person described in Section 514(c)(9)(B)(iii) or a disqualified person within the meaning of Section 4975(e)(2)(C), (E) or (G) with respect to the pension plan partner, or a person related, as described in Section 514(c)(9)(B)(iv)(II), to any disqualified person.

- Restriction that the partnership will not enter into any agreement to acquire any additional properties unless the partnership has obtained a representation and covenant from the seller that the seller is not related to the partnership or a tenant in a property or related to a tenant in a property by a relationship described in Section 514(c)(9)(B)(iii) or a disqualified person within the meaning of Section 4975(e)(2)(C), (E) or (G) with respect to the qualified pension plan partner, or a person related, as described in Section 514(c)(9)(B)(iv)(II), to any such disqualified person; and

- At any time that any property would otherwise be considered debt-financed property for purposes of Section 514, the partnership will meet the requirements of Section 514(c)(9)(B)(i) through (vi), such that any such financing will not constitute “acquisition indebtedness” for purposes of Section 514.

- A requirement for the partnership only to use union labor and to pay prevailing wage.

- Information requirements for the partners regarding the real estate investment trust status of a partner?

Other specialized partners may require other specialized provisions.

This is an example of a typical short-form provision where a REIT is a partner:
“REIT Qualification. REIT Member intends to qualify at all times as a ‘real estate investment trust’ (“REIT”) under Code Section 856. REIT Member’s ability to qualify as a REIT may depend, in part, upon the nature of the Company’s assets, income, and operations. In this regard, the Manager will cause the Company to endeavor to conduct its operations in a manner intended to enable REIT Parent to satisfy all the requirements for REIT status under Sections 856 through 860 (the “REIT Qualification Requirements”) and to prevent REIT Member from engaging in any “prohibited transaction” under Code Section 857(b)(6). The Manager will cooperate with REIT Member in selecting assets for ownership by the Company or disposing of Company assets, establishing leasing guidelines, negotiating leases and amendments to leases, and otherwise conducting Company operations. The Manager will cooperate (including, without limitation, by providing information and documents relating to the income and assets of the Company) with REIT Member in addressing issues raised by any taxing authority in any audit or similar proceeding relating to REIT Member that relate to or arise out of such REIT Member’s investment in the Company. In addition to the foregoing, without prejudice to generality, the Manager (i) will cause the Company to invest in assets and will structure leases and operations in such a manner that the Company’s rental income will qualify as “rents from real property,” (ii) will cause the Company to invest its assets in a manner and in assets designed to avoid causing the REIT Member not to violate the REIT Qualification Requirements, and (iii) will consider the REIT Qualification Requirements in selecting tenants and in determining or modifying the terms of leases and the services provided in connection with leases, and in otherwise conducting the business of the Company. The parties acknowledge that this Section x.x may require the Company (and the Manager is authorized to cause the Company) to forego otherwise advantageous business opportunities. The parties acknowledge that this Section x.x may affect the profitability of the Company. The parties acknowledge that (i) this Section x.x may preclude the Company from taking an action, or may require the Company to take an action that the Company would not have otherwise taken; and (ii) this Section x.x may adversely affect the profitability of the Company and may cause the Company to fail to pursue advantageous business opportunities. The parties’ intend that the Manager’s and the REIT Member’s fiduciary obligations of loyalty and care are modified by this Section x.x.

This is another similar short form provision:

REIT Member has elected to be characterized as a real estate investment trust (a “REIT”) under Code Section 856. The Manager will manage the business and affairs of the Company with a view to minimiz-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

ing or to eliminating these income items of the Company that are treated adversely under Code Section 856(c)(2). Qualifying income that is not taxed adversely under Code Section 856(c)(2) is income that qualifies as (A) dividends; (B) interest; (C) rents from real property; (D) gain from the sale or other disposition of stock, securities, and real property (including interests in real property and interests in mortgages on real property) that is not property described in Code Section 1221(a)(1); (E) abatements and refunds of taxes on real property; (F) income and gain derived from foreclosure property; (G) amounts (other than amounts the determination of which depends in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or lease real property (including interests in real property and interests in mortgages on real property); (H) gain from the sale or other disposition of a real estate asset that is not a prohibited transaction solely by reason of Code Section 857(b)(6); and (I) mineral royalty income from real property owned by a timber real estate investment trust and held, or once held, in connection with the trade or business of producing timber by the REIT Member. The Manager will manage the business and affairs of the Company with a view to minimizing or to eliminating these income items of the Company that are treated adversely under Code Section 856(c)(3). Qualifying income that is not taxed adversely under Code Section 856(c)(3) is (A) rents from real property; (B) interest on obligations secured by mortgages on real property or on interests in real property; (C) gain from the sale or other disposition of real property (including interests in real property and interests in mortgages on real property) that is not property described in Code Section 1221(a)(1); (D) dividends or other distributions on, and gain (other than gain from prohibited transactions) from the sale or other disposition of, transferable shares (or transferable certificates of beneficial interest) in other real estate investment trusts; (E) abatements and refunds of taxes on real property; (F) income and gain derived from foreclosure property; (G) amounts (other than amounts the determination of which depends in whole or in part on the income or profits of any person) received or accrued as consideration for entering into agreements (i) to make loans secured by mortgages on real property or on interests in real property or (ii) to purchase or to lease real property (including interests in real property and interests in mortgages on real property); (H) gain from the sale or other disposition of a real estate asset which is not a prohibited transaction solely by reason of Code Section 857(b)(6); and (I) qualified temporary investment income. The Manager will manage the business and affairs of the Company with a view avoiding all income from prohibited transactions under Code Section 857(b)(6). (The items of income that fail to qualify as income de-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

scribed in Code Section 856(c)(2). (3)(i) and (ii) and Code Section 857(b)(6) are referred to as “Nonqualifying Income”). The Company will not perform or provide any services to tenants which services would cause the Company to derive “impermissible tenant service income” under Code Section 856(d)(7). The Company will not derive any income from a lease that would cause the Company to derive income that fails to qualify as “rents from real property.” The Manager will manage the business and affairs of the Company with a view to minimizing or to eliminating assets that fail to qualify under Section 856(c)(4)(A). Qualifying assets under Section 856(c)(4)(A) are real estate assets, cash and cash items (including receivables), and Government securities. (Assets that fail to qualify under Section 856(c)(4)(A) are referred to as “Nonqualifying Assets.”) The Manager will manage the business and affairs of the Company with a view to ensuring that, except with respect to securities includible under Code Section 856(c)(4)(A): (A) not more than 5 percent of the value of its total assets of the Company are represented by securities of any one issuer; (B) the Company does not hold securities possessing more than 10 percent of the total voting power of the outstanding securities of any one issuer, and (C) the Company does not hold securities having a value of more than 10 percent of the total value of the outstanding securities of any one issuer. REIT Member shall be entitled to exercise any vote, consent, election or other right under this Agreement with a view to avoiding (or minimizing) the amount of Bad Income or Bad Assets of the Company or any material risk that REIT Member could be disqualified as a REIT or could be subject to any additional taxes under Code Section 857 or Code Section 4981.

All Members agree to consent to modifications proposed by REIT Member in good faith, if in any such case the modifications are necessary, in REIT Member’s judgment, and will not, in a Non-REIT Member’s judgment, do any of the following (each of which, individually an “Adverse Change”): (i) render REIT Member and/or its successors in interest unable to fulfill its financial obligations hereunder, (ii) subject any Non-REIT Member to materially greater liability or exposure for Capital Contributions or the claims of or any indebtedness owing to third parties, (iii) materially adversely affect the liquidity of any Non-REIT Member’s Membership Interest, (iv) materially adversely affect the aggregate amount or timing of or exposure for Capital Contributions, payment of fees, distributions of Distributable Cash, Net Capital Proceeds and liquidation proceeds or the aggregate allocations of Profits and Losses to Non-REIT Member, (v) reduce the Capital Account of any Non-REIT Member, (vi) materially adversely affect the rights of any Non-REIT Member under this Agreement; (vii) materially increase any Non-REIT Member’s obligations under this Agreement or (viii) materially increase any Non-REIT
Member’s income tax liability. The Members acknowledge that it is the intent of REIT Member to exercise its approval rights under this Section x.x in order to protect REIT Member’s members’ qualification as a REIT and to minimize the amount of any taxes that may be imposed on REIT Member. Without the prior written consent of REIT Member, the Company shall not (i) enter into any lease under which the determination of any rent to be received (directly or indirectly) by the Company depends in whole or in part on the income or profits of any person (other than amounts based upon a fixed percentage or percentages of receipts or sales); (ii) enter into any lease under which the Company will receive (directly or indirectly) rents attributable to personal property except for a lease under which the personal property is leased in connection with the lease of real property and the rent attributable to the personal property for any taxable year does not exceed 15% of the total rent for such year; (iii) enter into any arrangement under which the Company would receive (directly or indirectly) any “impermissible tenant service income” under Code Section 856(d)(7); (iv) undertake any sales or dispositions of property as a dealer for federal income tax purposes which sales would be treated as “prohibited transactions” under Code Section 857(b)(6)(B)(iii); (v) otherwise engage in any transaction which would, or likely would, result in the Company receiving more than a de minimis amount of Bad Income or owning more than a de minimis amount of Bad Assets.

53. Winding Up and Liquidation

Simplicio does not worry much about partnership liquidation. Liquidation should take care of itself. By then, Simplicio will be long gone. Salviati, however,drafts careful liquidation provisions. Salviati considers:

- What events should cause the partnership to wind up and to dissolve?
- What happens if one partner wishes to wind up and liquidate the partnership but the other does not?
- Clear triggers for liquidation.
- Qualifications of a liquidator.
- Appointment of a liquidator.
- Provision for expenses of liquidation.
- Provision for liquidation of an insolvent partnership.
- Clear definition of the powers of the liquidator.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Obligation to suspend unnecessary operations and to proceed toward the sale of partnership assets.
- A clearly defined period within which assets must be sold and distributions in liquidation just be made.
- Clear triggers on clawbacks.
- Termination of tax distribution payments.
- Provision for liability reserves and holdbacks.
- Provision for other reserves.
- Clear directions concerning mustering of assets and sale of assets.
- Clear priority of payments and amount of payments in liquidation.
- Provision for funding of partnership tax audits after liquidation.
- Provision for dealing with contingent partnership liabilities after liquidation.
- Provision for preservation of partnership records and files after liquidation.
- Provision for what happens to partnership clients and business relationships after liquidation.
- Possible compensation of the partnership estate on account of business retained by a partner after liquidation.
- Provisions regarding dealing with partnership goodwill and business opportunities after liquidation.
- Provision regarding collection of partnership receivables.
- Provision regarding partially completed partnership business projects.
- Provision regarding ownership of the partnership name after liquidation.
- Will partners have liability for deficit capital accounts?

54. Securities Law Concerns.

Few more reliable ways are available for Simplicio to compromise his partnership work than by issuing unregistered partnership interests in a nonex-
empt offering. Among other things, this should create a risk of rescission and other penalties.

This is not a text on securities law. The author is not a securities lawyer. This Article does not give securities law advice. Readers will have to look elsewhere for securities law advice. Readers are advised to consult with qualified securities counsel.

Draftsman, however, should recognize that partnership interests can be securities the offering of which can require appropriate securities registration or that otherwise may be offered in an exempt offering. Draftsmen should consider implications of both federal and state securities law. Anyone who does much partnership work should have a good contact who can advise authoritatively on securities law issues. This section merely introduces some securities law issues. Talk to a securities lawyer for advice on securities laws.

Securities are often defined with a disorienting lack of prevision. Securities are not expressly defined by the Securities Act of 1933, the Securities Exchange Act of 1934, or the Uniform Securities Act. Securities attorneys focus on “investment contracts” when they consider whether partnership interests are securities. The modern concept of “investment contract” is grounded on the 1946 United States Supreme Court opinion in Securities & Exchange Commission v. W.J. Howey Co. The Court there described an “investment contract” as “a transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of a promoter or third party.” Each aspect of this seemingly simple statement involves nuance well beyond the scope of this Article.

The current conventional wisdom is:

- A general partnership interest usually is not a security, but it can be a security in unusual circumstances.
- A limited partnership interest usually is a security, but perhaps it is not a security in unusual circumstances.
- The law is developing concerning limited liability company interests as securities, but a case can be made that the typical member managed limited liability company interest usually is not a security.

---

489 328 U.S. 293 (1946).
490 Id. at 298-99.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- The law is developing concerning whether a manager managed
limited liability company is a security.

    Salviati will conclude from this the importance of discussing the situation
with securities counsel when he forms a partnership. Simplicio will not worry
about securities law issues. Securities law issues will take care of themselves.

    Salviati’s first step is to determine whether an offer of interests in a part-
nership is an offering of securities. Salviati next should determine whether the
offering is exempt from registration under federal and state securities laws.

    The Securities Act of 1933 generally regulates offers for the sale of secur-
ties either in the United States or using instruments of interstate commerce. This
includes securities offerings that use the internet, United States telephone lines,
the United States mail. This is a broad net. Practically any offering of securities in
the United States or from the United States is potentially subject to the Securities
Act of 1933 as a practical matter.

    The Securities Act of 1933 identifies two general categories of securities
offerings – exempt and nonexempt. An exempt offering falls under a specific ex-
emption under the Securities Act of 1933. A nonexempt offering requires registra-
tion of the securities offering with the Securities and Exchange Commission. The
nonexempt offering typically must file a detailed registration statement with the
Securities and Exchange Commission setting for information about the partner-
ship, the securities, and the offering of securities. Preparation of the registration
statement is a substantial amount of work and is expensive. The issuer must file
the registration statement prior to the partnership offering securities in a nonex-
empt offering. A filing company is also subject to requirements regularly to report
additional information to the Securities and Exchange Commission.

    The time, effort, and money required to prepare a registration statement
encourages the issuer to seek an exemption, if available. The consequences of is-
suing nonexempt securities without proper compliance with the securities law is
an ability of the offeree to rescind after purchase and the violation of the Secur-
ties Act of 1933. The Securities and Exchange Commission is aggressive in pur-
suing violators. They can seek civil sanctions or even prosecute violators in ex-
treme cases. These consequences are unattractive.

    The typical registration statement uses Form S-1. This form requires ex-
tensive information about the issuer, its financials, the securities, and the offering.
The filing also requires filing a prospectus that describes the issuer’s business op-
erations, financial condition, results of operations, risk factors, and management.
The prospectus containing this information must be delivered to all offerees. The
filing also must include audits financial statements prepared under Generally Ac-
ccepted Accounting Principles (or international accounting standards in the case of
foreign companies) and meeting the requirements of Regulation S-X.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Reduced reporting requirements are available for certain “smaller reporting company.” The issuer may choose to prepare the disclosure in the prospectus relying on disclosure requirements that are scaled for smaller companies.

Reduced reporting requirements also are available for an issuer that is an “emerging growth company.”

A nonexempt issuer is subject to regular filing requirements with the Securities and Exchange Commission. For smaller businesses, these filing requirements reinforce the importance of qualifying for an exemption, if available.

An offering is exempt under federal securities law may requiring filing with state securities authorities.

Salviati ensures that his unregistered offerings of partnership securities comply with a nonpublic offering exemption (or “private offering exemption” or “private placement exemption”). The nonpublic offering exemption exempts from compliance with the registration requirement under the Securities Act of 1933 “transactions by an issuer not involving any public offering.”

The non-public offering exemption looks to the sophistication of the offerees. The offerees of the partnership securities must:

- Either –
  - Have enough knowledge and experience in finance and business matters to be “sophisticated investors” who are able to evaluate the risks and merits of the investment, or
  - Be able to bear the investment’s economic risk;
- Have access to the type of information normally provided in a prospectus for a registered securities offering; and
- Agree not to resell or distribute the securities to the public.

Public advertising of the offering, and general solicitation of investors, is generally not allowed for a non-public offering.

---

491 See Item 10(f)(1), Regulation S-K. An issuer qualifies as a “smaller reporting company” if (i) its public equity float is less than $75 million, or (ii) if the issuer cannot calculate its public equity float, it has less than $50 million in annual revenue. The requirements are found in paragraphs labeled “smaller reporting companies” in Regulation S-K and in Article 8 of Regulation S-X.
Rule 506 of Regulation D is used to determine a non-public offering exemption. Regulation D contains three exemptions from registration under the Securities Act of 1933: the “seed capital” exemption (Rule 504), an exemption for offers and sales of securities totaling up to $5 million in any 12-month period (Rule 505), and nonpublic offering exemption (Rule 506).

Rule 506 provides a “safe harbor” for the non-public offering exemption. This exemption requires that the issuer partnership:

- Not use general solicitation or advertising to market the securities;
- Not sell securities to more than 35 non-accredited investors;
- Give non-accredited investors specified disclosure documents that generally contain the same information as provided in registered offerings;
- Be available to answer questions from prospective purchasers who are non-accredited investors; and
- Provide the same financial statement information as required under Rule 505.

An “accredited investor” is:

- A bank, insurance company, registered investment company, business development company, or small business investment company;
- An employee benefit plan if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;
- A tax exempt charitable organization, corporation or partnership with assets in excess of $5 million;
- A director, executive officer, or general partner of the company selling the securities;
- An enterprise in which all the equity owners are accredited investors;
- An individual with a net worth of at least $1 million, not including the value of primary residence;
- An individual with income exceeding $200,000 in each of the two most recent calendar years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or
A trust with assets of at least $5 million, not formed only to acquire the securities offered, and whose purchases are directed by a person who meets the legal standard of having sufficient knowledge and experience in financial and business matters to be capable of evaluating the merits and risks of the prospective investment.

Offerings often are limited to accredited investors. This avoids the requirement to prepare offering materials. Practitioners nevertheless must consider the antifraud provisions of the securities laws.

Practitioners also must consider compliance with state securities laws.

55. General Drafting Considerations.

Few legal tasks are less appreciated or harder than drafting partnership, limited partnership, and limited liability company agreements (“partnership agreements”). (This Article will refer to general partnerships, limited partnerships, limited liability partnerships, and limited liability companies collectively as “partnerships.”) Drafting effective partnership agreements is hard for even the most experienced specialist practitioner. The rules surrounding drafting partnership agreements are so extensive and so complicated that it is uncertain whether anyone fully understands them all. One of the most important steps in the professional development of every draftsmen of partnership agreements may be admitting how much he does not know and how limited his drafting skills are. Improving those skills is a long-term task.

Most partnership agreements are drafted by less experienced draftsmen—with predictable results. Drafting often is delegated to a junior associate with little formal training in drafting partnership agreements. He is sent off to his office with a tired, well-worn form partnership agreement and a few scribbled notes containing information to fill in the blanks in the form. The most stressed and important instructions to inexperienced draftsmen often are to labor quickly so as not to run up the client’s bill, and not to waste time reading or departing from the form—that is tried and true. The result often is unsatisfactory.

The state of the art in drafting partnership agreements too often is a low standard of quality. Many partnership agreements, even when drafted by prestigious law firms, contain bad economic errors—or noneconomic errors—or inadequacies. Partnership agreements often fail to resolve basic issues in the life cycle of a partnership. Neglected issues include funding a post-liquidation tax audit, conducting a partnership tax audit, providing fair market value information for all contributed assets, and selecting a method to apply the rules for computing depre-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

ciation and gain on sale on property contributed to the partnership with a “book”-tax disparity.

You may feel like a tourist in a foreign land whose language you do not speak when you draft a partnership agreement. This Article provides an introduction to some of the basic tax rules and terminology involved in drafting partnership agreements.493

This Article will not teach you how to draft partnership agreements. This Article may help to teach you to teach yourself how to draft partnership agreements. This Article is written to help you to identify common deficiencies in real estate partnership agreements – and ideally to help you to improve your skill and

493 Many of these rules are complex indeed. Even dedicated tax practitioners are troubled by many complex aspects of drafting partnership allocations and applying Treasury Regulations. Complicated partnership allocations normally are the province of an experienced tax attorney. You may be an inexperienced draftsman. Consider having someone knowledgeable in partnership allocations review the allocations that you draft. Run numerical examples that forecast how allocations will work under a variety of economic assumptions. Work with partnership accountants to confirm that allocations work and to confirm that allocations are understandable. Consider providing that the partnership will liquidate in accordance with specified percentages or tiers of percentages, rather than in accordance with partners’ capital accounts, if you are unsure of your allocations. Even many experienced draftsmen opt in favor of liquidating in accordance with specified percentages or tiers of percentages (or returns) rather than in accordance with partners’ capital accounts. This can be an entirely sensible practice, especially where complicated economic schemes make final capital account balances uncertain. Effective practitioners, however, are sensitive to the effects of partnership allocations on capital accounts, even if their partnership agreements liquidate by specified percentages or tiers of percentages (or returns). The rules governing partnership allocations are principally contained in Treas. Reg. §§ 1.704-1, 1.704-2. For simplified and shorter discussions of this subject, see Terence Floyd Cuff, “A Personal Perspective on Drafting Partnership and LLC Agreements,” Terence Floyd Cuff, “Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements,” Leslie H. Loffman and Sanford C. Presant, “Selected Tax Allocation Problems For Partnerships and LLCs,” Leslie H. Loffman and Sanford C. Presant, “Selected Operating Agreement Tax Allocation Provisions For Limited Liability Companies,” all in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006.
understanding. You will be able to draft higher quality real estate partnership agreements if you are able to identify basic problems.

56. **General Comments about Drafting Partnership Agreements.**

a. **Drafting Principles.**

These basic principles have served me well. Consider them when drafting and reviewing partnership agreements.

- Agree on a detailed memorandum of understanding (or letter of intent) before proceeding to draft your partnership agreement.
- Think before you draft.
- Act as an attorney and not merely as a scrivener.
- Work cooperatively with the partnership accountants. Hang together or you may hang separately.
- Be a little afraid when you are drafting a partnership agreement. Have more fear of the damage that you can do through making drafting mistakes than fear of your supervisor’s or client’s criticism for taking too much time drafting your partnership agreement.
- Understand the deal.
- Understand your client’s business.
- Understand the applicable laws.
- Avoid oppressive provisions. You are more likely to be able to enforce provisions that are fair, just, and equitable than you are to be able to enforce provisions that are oppressive. In barnyard language, pigs get fat; hogs get slaughtered.
- Call in more sophisticated reinforcements when necessary.
- Think through the life cycle of your partnership in reverse from dissolution through formation. Address all material anticipated issues in this life cycle.
- Address pertinent issues while drafting your partnership agreement (as opposed to later when these issues come into play during the course of business and when partners may not be so friendly).
- Address the continuing relationship of the partners. A partnership is much more than just a single transaction. The partnership is a
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

continuous series of transactions beginning at formation and perhaps ending with a post-liquidation tax audit.

• Never blindly assume that anything in your form agreement is correct.

• Include in your partnership agreement only provisions that you understand completely.

• Draft provisions that will work even when the partners become hostile; partnership terms may have to be applied in litigation. Do not depend on the friendliness or good faith of partners to resolve all problems.

• Understand the limitations of your own understanding of the drafting rules. Do not draft over your head. Do not draft a more complex partnership agreement than you can understand.

• Draft clearly and unambiguously.494

• Seek to achieve simplicity – at least, as much simplicity as reasonably possible considering the complexity of the deal.

• Observe rules of grammar and good composition.

• Seek to reduce sentence and paragraph length and complexity. Short sentences usually are easier to understand than long sentences. Short paragraphs usually are easier to understand than long paragraphs.

• Organize your partnership agreement sensibly into articles and sections, paragraphs and subparagraphs.

• Use descriptive titles and subtitles.

• Provide a table of contents.

• Review your finished product repeatedly.

• Read every provision slowly and carefully.

• Search diligently for hidden problems – treat the review process like an Easter egg hunt; searching for flaws.

494 There may be practical limits to how unambiguous you may want your drafting to be. It is rare to encounter a partnership agreement for a 50/50 partnership that is clear on precisely how to allocate a 99 cent distribution between the two partners. Partners usually are willing to accept some degree of drafting imprecision as the price of economic efficiency. Draftsmen, however, too often go beyond reasonable limits in their drafting imprecision.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Test all numerical provisions (particularly allocation, distribution, and dilution provisions) with numerical examples covering all classes of cases, whether or not these cases seem likely to occur.  
- Verify all statutory references, cross references, and defined terms.
- Review provisions until you understand them.
- Have someone else review the partnership agreement once the draft is complete.
- Work with the partnership accountants in drafting allocation and distribution provisions.
- Think. That is what you are being paid to do. Do not behave like a potted plant.

b. Whom Do I Represent?

Know whom you represent. Resolve any ethical conflicts of interest, particularly those that may be created by representing both the promoter and your

---

495 Test allocations with different orders of income and loss and fluctuations between the two. Test allocations with income preceding losses, followed by income, and then losses preceding income, followed by losses. Test allocations with income following cash flow, cash flow following income, and fluctuations between the two. Compute projected capital accounts.

496 Follow Brendan Sullivan’s advice to Senator Daniel Inouye (“I am not a potted plant. I’m here as a lawyer. That’s my job.”) during the Iran-Contra hearings. Part of the thinking process is whether your entity should be formed as a general partnership, limited partnership, limited liability company, or perhaps it should be formed as an S corporation or a C corporation.

C corporations are advantageous for entities that will be owned by large numbers of shareholders. They also may be best for certain types of special purpose entities, such as real estate investment trusts and regulated investment companies. C corporations can engage in merger transactions under the rules of corporate tax. C corporations also provide for carryover of net operating losses. C corporations are particularly distinctively taxable entities. They file their own tax returns and pay their own tax. C corporations may have certain advantages in paying fringe benefits to employees. C corporations are subject to tax at the corporation level, and their shareholders are taxable on dividends. A shareholder’s heirs receive an increase in tax basis in the shares of the C corporation on the shareholder’s death, but not in the C corporation’s assets.

An S corporation is a corporation that has elected to be taxable under the special tax regime of subchapter S.
partnership. Be careful in resolving ethical conflicts if you represent both a partner and your partnership. Be particularly careful of ethical conflicts if you represent more than one partner in organizing your partnership. An inherent ethical conflict exists between the interests of the different partners and your partnership. Resolve these ethical conflicts before you begin your representation.  

\[497\]  

\[C.\quad \text{The Form Agreement.}\]  

Professionals are under tremendous pressure to offer work product that, in a phase borrowed from Dan Goldin of NASA, is “better, faster, cheaper.” “Better, faster, cheaper” usually means faster. “Better, faster, cheaper” often means cheaper. “Better, faster, cheaper” rarely means higher quality – and almost invariably means sacrificing quality to immediate economy.  

Drafting partnership agreements tests the skills of even the most proficient real estate or corporate practitioner, estate planner, or partnership tax attorney. Drafting an effective partnership agreement is a challenge for even the most experienced specialist practitioner. Many draftsmen fail to recognize sophisticated problems and danger areas.  

Partnership agreements too often suffer from false economy, inexperience, and inattention to detail of the draftsman (or his supervisor) and from the pressures placed on the draftsman by his clients (or his supervisor) to contain costs. Partnership agreements too often suffer from the draftsman not understanding his form.  

---  

\[497\] Consider including in your partnership agreement a provision that explicitly states precisely whom you represent. Consider also including a statement explicitly stating who represented other partners or a general statement that the other partners were represented by separate counsel and not by you.  

\[498\] Consider the many tax issues in addition to those discussed in this Article and the many tax and nontax issues beyond the scope of this Article. For example, consider the family partnership rules of I.R.C. § 704(e) and the special valuation rules of I.R.C. § 2701-4. Consider the effects of a series of disguised sales rules variously under I.R.C. §§704(c)(1)(B), 707(a)(2)(B), and 737. Consider the investment company rules of I.R.C. § 721(b) that can cause contributions to certain partnerships to be fully taxable; these rules particularly should be considered if a partnership includes securities as assets. I.R.C. § 724 will lock in ordinary character on contributed unrealized receivables and contributed inventory items and will lock in the capital character of capital loss property. Consider potential of gain recognition on account of recapture of losses where at risk is less than zero under I.R.C. § 465(e). Consider the medley of tax provisions that can be affected by dispositions of property through a contribution to a partnership.
Partnership agreements may provide for a cash distributions scheme different from what one or both partners expect at the liquidation of the partnership. Another frequent problem is that one partner undertakes or wishes to undertake actions that may breach fiduciary duties owed to another partner or to the partnership. Many partnership disputes are grounded on poor drafting of the partnership agreement and failure to model mathematically or to understand the economic scheme contained in the partnership agreement.

Forms are a useful starting point in drafting partnership agreements. Re-think the form with each deal. No provision in your partnership agreement is mere boilerplate. Test each provision. Give each sentence due consideration. Each sentence has legal importance.

Language in sample provisions included in this Article has generally been extracted or adapted from actual partnership agreements rather than created as a textbook or ideal solution. Consider this language as a possible starting point for your consideration, not a template for all of your drafting. Take this language as illustrative, but not ideal. You will have to do your own drafting.

d. Your Team.

Draft and test your partnership agreement as a team effort, if you can. The ideal team includes your client, corporate or real estate attorneys, the tax attorney, your client’s in-house accounting staff or outside accountants, and financial modelers – perhaps working in-house for your client, but more often working for the outside accountants. (Do not overlook the invaluable contributions of your secretary, word processors, and proofreaders.)

Your client helps to negotiate and to craft the deal. (Not insignificantly, he pays the bills and ultimately calls the shots. Make sure he understands the potential costs.) One of the dangers of the drafting process is that your client often does not fully understand the subtleties of his economic deal (and often is impatient with subtleties and details). This is a danger even though he perhaps thinks that he understands the subtleties of his economic deal. Success in business does not translate into sophistication in crafting partnership relationships and partnership agreements.

Corporate or real estate attorneys take responsibility for negotiations and general legal aspects of the partnership agreement, securities law considerations, management, voting, due diligence, transfer of the property, fiduciary duties, regulatory compliance, environmental, etc.

The tax attorney advises on tax aspects of contributions, the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis, partnership allocation and distribution provisions,
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

squeeze-down provisions when a partner defaults on his capital contribution, liq-
 uidation provisions, and tax audit provisions.

Your client’s in-house accounting staff or outside accountants are partic-
 ularly important. Work with your partnership’s accountants and in-house account-
 ing staff to ensure both that they understand your partnership agreement and that
your partnership agreement accurately reflects the economic deal.

Your client’s in-house accounting staff or outside accountants will have to apply
your partnership agreement in practice and to complete the partnership tax
return. Your partnership agreement may be a model of drafting elegance. Your
partnership agreement can be a failure if the junior accountant who prepares the
partnership tax return cannot understand your partnership agreement. Draft with
sufficient clarity that your partnership agreement can be interpreted properly by
junior accountants. These junior accountants likely will be the ones interpreting
your partnership for normal partnership operations. These junior accountants will
prepare the annual partnership return. They likely will just do what they think is
“right” if they cannot understand your partnership agreement. That could produce
a result different from what you intend.

Many accountants – if only in moments of candor late at night or in the
bar – will admit that they often do not read – or, at least, often do not understand –
the partnership agreement when they prepare partnership tax returns. Involving
accountants in the drafting process increases the likelihood that the partnership
tax return will conform to what the partnership agreement says. Involving ac-
countants in the drafting process may encourage you to simplify the language and
structure of partnership allocations so that the partnership accountants can unde-
stand the allocations.

Financial modelers – who may be the accountants or simply may be spe-
cialists in financial modeling – can provide invaluable support. Financial model-
ners too often are not involved in the process. Financial modelers can prepare
spreadsheets showing the effects of different methods of applying the partnership
tax rules concerning contributed property with differences between fair market
value and adjusted tax basis, projecting exposure to recognizing gain under dis-
guised sale rules or gain from liability relief (both at formation and in the future),
and quantifying the long-term effects of partnership allocation and distribution
provisions. Financial modelers ideally will prepare projections under a variety of
economic scenarios so that your client can understand the economic effects of
your partnership agreement. The work of the financial modelers is invaluable in
negotiating and preparing your partnership agreement. Their work can be critical
in exposing flaws in partnership allocation or distribution provisions and in inves-
tigating concerns under disguised sale rules and partnership liability relief rules.
Neglecting the financial modelers puts the negotiators at a disadvantage. The ne-
gotiators will be left to negotiate blind – only partially understanding the economic deal in the absence of good projections.

Omitting these critical team members is supposed to save money. The savings can prove to be false economy. Omissions delete critical quality controls. Omissions often can lead to mistakes and to misunderstandings. You have an important task in ensuring that your client understands the risks of eliminating these quality control inspectors.

e. Draft to Address the Litigation Threat.

Draft for litigation. Assume that the parties will end up in litigation in which each paragraph is challenged. Many partnership agreements end up in disputes or in litigation. Attorneys in litigation spend many hours seeking interpretations of provisions favorable to their client’s interest. Litigators seek to tease each nuance from each phrase, each word, and even each mark of punctuation.

You may take only a few minutes to draft a provision. Attorneys in litigation may spend months or years disputing precisely what the provision means. Attorneys read provisions of a partnership agreement much more carefully during litigation than these attorneys read these provisions during the drafting stage.

Few draftsmen draft with the care that they would employ if they knew that their work would be disputed in litigation. Litigation experience teaches invaluable drafting skills.

Think through each provision. Think through each sentence with sufficient care for your partnership agreement to stand up in litigation.

Draft a partnership agreement that will stand up to the day-to-day demands of partnership operations and to the perils of litigation.

f. Good Writing.

Consider principles of good writing and clarity in addition to considering principles of law. Simplify and clarify as much as you reasonably can. Your partnership agreement will not be effective if the partners and the partnership accountants cannot understand and apply its provisions. Your partnership agreement will not be better than others’ ability to understand it. Do be a slave to the language of your partnership agreement form if you can simplify your partnership agreement and make it more understandable.

Understandability is as important in drafting as analytical precision. Many partnership agreements are so complex that partners and accountants are more inclined to apply what those partners and accountants suppose the partnership agreement means rather than what the partnership agreement says. Some form partnership agreements are burdened by long, heavy definitions that are unlikely to be read.
Most agreements are written in a dialect that might be described as “law English.” Few nonlawyers are comfortable with reading (or understand) law English. Writing simply and in “plain English” is a worthwhile objective. Partnership agreements can be difficult to read and to interpret, at best. Help your reader to understand the agreement through good drafting. An important test is whether the partnership accountants can apply the terms of your partnership agreement. An ultimate test of a partnership agreement is whether a jury can understand your partnership agreement. Writing an agreement that is understandable to laymen is a good objective. (The excerpts from partnership agreements contained in this Article are taken from real partnership agreements and often are not good examples of simple and understandable writing.)

57. Cash Capital Contributions.

Capital contributions often are made in cash. Address the contribution required of each partner, the currency in which it is to be made, the time by which it must be made, and whether it should be made in immediately available funds or by cheque (and, if a cheque, whether the cheque must be a cashier’s cheque). In either case, the contribution should be made in United States dollars unless otherwise stated. The precise date when capital contributions are made is particularly important when your partnership agreement contains a preferred return. 499

Partner agreements sometimes contain complex provisions that deal with a long period of rolling admissions or “staged contributions.” 500 These partnership agreements can create additional issues that are outside of the scope of this Article. Engage a specialist in partnership taxation if your partnership will have rolling admissions (admission of different investor groups at different times) or “staged contributions.”

This is a simple provision concerning initial capital contributions:

Section x.x. Required Capital Contributions.

(a) Initial Contributions; Capital Account.

(i) Each Member shall contribute (as a Capital Contribution to the Company) the amount in cash set forth opposite that Member’s name on Exhibit A (each, an “Initial Contribution”).

---

499 Defaults on capital contributions are considered in the text at note 783.

500 If your partnership provides for rolling admissions, consider the effects on creating nonfungible partnership interests on account of interim allocations between the different admission dates.
(ii) Each contribution shall be made within five (5) Business Days following notice from the Manager. Each contribution may be made in one or more installments as requested by the Manager.

(iii) The Initial Contributions shall be made in immediately available funds in United States dollars.

(iv) The Company shall establish and maintain a separate Capital Account for each Member.

(b) Additional Capital Contributions.

(i) The Manager shall issue a written demand for additional capital contributions if the Manager determines that Capital Contributions in excess of the Initial Contributions are required to fund operations within the scope of the primary purpose of the Company. This determination shall be made in the Manager’s sole and absolute discretion.

(ii) The written demand shall require that the Members contribute the amount of Additional Capital Contributions (each, an “Additional Capital Contribution”). These Additional Capital Contributions, together with all other Additional Capital Contributions made by the Members, in no event shall exceed (in the aggregate) x percent (x%) of the aggregate amount of the Initial Contributions of all of the Members.

(iii) Members shall contribute Additional Capital Contributions in proportion to their Percentage Interests.

(iv) Each Member shall contribute its share of Additional Capital Contributions in immediately available funds in United States dollars within five (5) Business Days after the date the written demand for Additional Capital Contributions is delivered to that Member.

(c) No Other Required Contributions. No Member shall be required to make any other Capital Contributions, except as otherwise expressly required by this Agreement.

(d) Failure to Make Required Contribution. The failure of a Member (a “Non-Contributing Member”) to contribute in a timely manner its full share of any Mandatory Contribution, shall constitute a Default under this Agreement. The remedies set forth at Section y.y shall be available to the Company and the other Members.

This is another provision concerning additional capital contributions:

Section x.x. Additional Capital Contributions.

(a) Additional Capital. No Member shall be required to make any further Capital Contributions to the Company after the Closing unless
and until the Management Committee has approved further Capital Contributions (following a request for approval by the Manager or any member of the Management Committee). If further funds are required to pay the obligations of the Company in excess of the funds available from –

(i) The Members’ Initial Capital Contributions and any prior contributions of Additional Capital;

(ii) The revenues derived from the Project; and

(iii) The Project Loan(s) made to the Company relating to the Project;

the Manager or any member of the Management Committee may propose to the Management Committee that additional sums be contributed by the Members to pay those obligations. These additional sums are referred to in this Agreement as “Additional Capital.” Without limiting the foregoing, the Manager shall promptly notify the Management Committee in writing after determining that Additional Capital is necessary to make up for shortfalls in then-current Annual Budget for the Project. The Management Committee afterwards shall have the right (in its sole and absolute discretion) to call on the Members (in writing) to contribute Additional Capital.

(b) Call Procedures; Payment of Call. Whenever the Members make a contribution of Additional Capital to the Company, each Member shall contribute its share of that Additional Capital (in immediately available funds in United States dollars) in an amount equal to –

(i) That Member’s Additional Capital Percentage multiplied by

(ii) The aggregate dollar amount of the call.

Calls for Additional Capital shall be made by written Notices to the Members in substantially the form of Exhibit “X”.

Notices –

(i) Shall specify the amount to be contributed in the aggregate and the amount to be contributed by the Member to which the call is directed,

(ii) Shall be sent to all Members, and

(iii) Shall be executed by a member of the Management Committee or by any other Person given the authority to execute the Notices by the Management Committee.

The Management Committee shall limit calls for Additional Capital to one call per calendar quarter. The Management Committee shall
cause Notice of calls to be given at least five (5) Business Days prior to the date the call is payable. To satisfy any call for Additional Capital, a Member shall contribute to the Company immediately available funds (in United States dollars) in the full amount of the Member’s share of the call on or before the first (1st) day of the immediately following calendar quarter (the “Contribution Date”). Contributions of Additional Capital shall be credited to the respective Capital Accounts of the Members when made.

(c) Additional Capital. Notwithstanding Section x.x(a), the Members shall be required to make contributions of Additional Capital to the Company (upon a call by the Management Committee) as and when required to fund operating deficits and the costs of capital improvements for the Project (if the purpose and amount of each cost has been expressly included in the most recent Annual Budget for the Project approved by the Management Committee).

Partnership agreements often have provisions concerning additional capital contributions. Clarify who may authorize the call for additional capital, what limits govern the amount of additional capital that partners can be required to contribute, whether additional capital contributions are required or discretionary, what procedures are required for the capital call, when additional capital contributions are due, and in what form the cash will be contributed (for example, by wire transfer of federal funds).

58. In-kind Capital Contributions.

Real estate partnerships may be formed with in-kind capital contributions of property by one or more partners. Partnership agreements may be deficient in setting forth appropriate terms for in-kind property contributions. These terms can be incorporated in your partnership agreement or in a separate capital contribution agreement. This contribution agreement often is a substantial document. Provide practically all of the provisions of a well-drafted purchase and sale agreement (warranties and representations, closing conditions, perorations, title insurance, etc.). A long-form purchase and sale agreement often is a good starting point in drafting your partnership agreement provisions governing in-kind capital contributions. A comprehensive contribution agreement, however, will go beyond a standard purchase and sale agreement perhaps to include a comprehensive tax protection agreement to indemnify contributors from the effects of the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis. The contribution agreement may contain covenants to permit contributing partners to guarantee partnership indebtedness in order to avoid problems from debt relief under the partnership tax rules concerning liability relief, from at risk recapture under Section 465(e), and from the effects of dis-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

guised sale rules. You often can evaluate your drafting skill from the quality of your contribution agreement provisions. These are some typical issues to address in a well-drafted in-kind capital contribution provision:

- Description of transferred property.
- Escrow provisions.
- Conduct of property investigation, mechanical systems inspections, etc.
- Delivery of documents and schedules concerning property.
- Service contracts concerning property.
- Property leases.
- Title documents.
- Surveys.
- Permitted title exceptions.
- Existing financing.
- Conditions to closing.
- Closing date.
- Closing procedures and deliveries.
- Prorations (operating expenses, insurance, utilities, real estate taxes, interest, rents, security deposits).
- Closing costs (escrow costs, title costs, title insurance, taxes).
- Property tax appeals and refunds.
- Post-closing adjustments.
- Transfer of service contracts.
- Transfer of possession of property.
- Employees.
- Warranties and representations.
- Environmental indemnity.
- Survival of warranties and representations.
- Interim operation of the property.
- Defaults and remedies.
- Interim casualties.
- Eminent domain.
- Treatment of warranty payments.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Service marks, trade names, etc.
- Schedule of contributed assets (with fair market value and adjusted tax basis of each contributed asset).
- Legal description of property.
- List of materials transferred (form of leases, property contracts, equipment leases, management agreements, engineering studies, environmental reports, termite inspections or warranties, equipment warranties, guaranties or warranties with respect to the roof, ad valorem and personal property tax statements, operating statements, insurance claims, pending litigation, notices of noncompliance, asbestos containing materials plan, operations and maintenance plans, certificates of occupancy, permits, etc.).
- Agreed form of deed.
- Agreed form of bill of sale.
- Agreed form of assignment of leases.
- Agreed form of notice to tenants.
- Possibly, a tax protection agreement.\(^{501}\)

Consider that the contributor may have to make cash payments to satisfy breached warranties. Clarify the intended capital account treatment of these warranty payments. You may not want warranty payments to increase the capital account of the partner making the warranty payments. Consider explicitly stating that warranty payments do not increase capital account.

A special tax provision (Section 704(c)(1)(A)) governs allocations of future depreciation and gain or loss with respect to contributed property in situations in which a difference exists between date-of-contribution fair market value and adjusted tax basis ("book"-tax disparity\(^{502}\)). Select the methodology that your partnership will use to apply these tax requirements.\(^{503}\) The selection of a particular method can surprisingly advantage or disadvantage your client. Good projections are essential in determining how important the selection of a particular method will be to your client. The frequent default of letting the manager decide the method to use under this special tax provision makes as little sense as letting the manager arbitrarily set percentage interests in your partnership. The "traditional method" often favors the contributor of property. The "remedial method" or "traditional method with curative allocations" often favors the noncontributing

---

\(^{501}\) See text accompanying note 660.

\(^{502}\) I.R.C. § 704(c)(1)(A).

\(^{503}\) See Treas. Reg. § 1.704-3.
partners. Your partnership agreement should select the method to use for taking into account the “book”-tax disparity.

Consider how these provisions will apply if the property is contributed further to a subsidiary partnership – or whether such a contribution should be permitted. You may agree to apply the traditional method in your partnership; a subsidiary partnership to which property is further contributed could apply the remedial method. Furthermore, income and loss allocations should be adjusted to consider this special tax law. Consider whether a tax distribution provision should make tax distributions to defray tax on gain that is allocated to a partner under this special tax law. Tax distributions, if not constructed as draws, can distort the economic deal.

Rules concerning tax allocations with respect to contributed property often apply on an asset-by-asset basis. Land and improvements are treated as separate assets for this purpose. Different improvements (for example, different buildings) may be different assets for this purpose. Schedule the agreed fair market value and adjusted tax basis of each contributed asset, separating land from improvements. Your partnership accountants will smile and be appreciative.

Consider a lock-in provision that prohibits your partnership from selling contributed property during a defined period of time after the date of contribution. Your partnership may sell contributed property in the absence of lock-in provisions. The contributor may suffer a substantial tax liability. This tax liability can far exceed cash distributions to the contributor. The problem with a lock-in provision is that it does not permit your partnership to take advantage of favorable market conditions to dispose of the property or to exchange its property. Lock-in provisions often contain exceptions that permit partnerships to exchange the contributed property in a non-taxable exchange or to sell the contributed property in a taxable transaction if your partnership indemnifies the contributing partner from the resulting tax liability. These indemnification provisions are long, detailed, and complex. Among other things, tax indemnification provisions need to account for different state tax rates and different federal tax taxes that might apply to the transaction. A tax indemnification provision for a contributing partner might contain a claw back of indemnification payments when the partner subsequently sells his partnership interest and would have recognized built-in gain even if your partnership had not sold contributed assets. Tax indemnification provisions on contributed property require much thought and careful drafting.


My allocations are net “book” allocations. These allocations allocate net “book” income and net “book” loss using “book” income and “book” loss in the sense of items that increase or decrease capital accounts under Treasury Regula-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

tions on capital account accounting.\footnote{\textsuperscript{504}} “Book” income and “book” loss adjust capital accounts maintained in accordance with the accounting scheme in Treasury Regulations for capital account maintenance.\footnote{\textsuperscript{505}} The distinction between taxable income and “book” income results from your partnership’s inheriting a partner’s adjusted tax basis in contributed assets (or from a revaluation of partnership assets). Your partnership credits the contributing partner’s capital account with the fair market value of contributed assets. The starting point in computing taxable income is your partnership’s adjusted tax basis in the contributed property.

Treasury Regulations on drafting partnership allocations introduce “book” income and “book” loss: \footnote{\textsuperscript{506}} This is not book income or book loss as the term “book” might be used by an accountant familiar with Generally Accepted Accounting Principles. “Book” income in the partnership tax sense is income determined (under general federal income tax principles) with reference to the “book” value of partnership property – the fair market value of the property at time of contribution adjusted by depreciation (based on depreciation of that fair market value but otherwise applying tax principles). A partner contributes real property with a fair market value of $5 million and tax basis of zero. The sale of the contributed real property will produce $0 “book” income (sale for $5 million and “book” basis of $5 million) if it is sold immediately after contribution. “Book” income generally is income of your partnership computed using fair market value of partnership assets (on date of contribution) as the starting point, but otherwise adjusting their adjusted “book” bases and computing “book” income in accordance with federal income tax principles. “Book” loss is loss of your partnership computed using fair market value of partnership assets (on date of contribution) as the starting point, but otherwise adjusting their adjusted bases and computing “book” loss in accordance with federal income tax principles. “Book” gain is gain of your partnership computed using fair market value of partnership assets (on date of contribution) as the starting point, but otherwise adjusting their adjusted bases and computing “book” gain in accordance with federal income tax principles.

Drafting partnership allocations by using “book” income and “book” loss rather than taxable income and taxable loss has advantages. Some special allocations in Treasury Regulations (for example, the minimum gain chargeback and qualified income offset) are based on allocations of “book” income rather than taxable income. Many of the controls on partnership allocations contained in Treasury Regulations are based on “book” income and “book” loss. The entire

\textsuperscript{504} Treas. Reg. § 1.704-1(b)(2)(iv).
\textsuperscript{505} Treas. Reg. § 1.704-1(b)(2)(iv).
\textsuperscript{506} See Treas. Reg. § 1.704-1(b)(2)(iv)( f ), (g).
scheme of substantial economic effect is based on “book” income and loss rather than taxable income and loss. “Book” income and “book” loss – not taxable income and taxable loss – adjust partnership capital accounts when maintained in accordance with the Treasury Regulations on partnership allocations.\textsuperscript{507}

Draft allocations of net “book” income and net “book” loss. Those allocations are net concepts – netting gross items of “book” income and gross items of “book” loss. Your partnership will have either net “book” income or net “book” loss in a single year, but not both. Designing economic tiers with these net concepts generally is easier than designing tiers with allocations of gross income items and gross loss items.

The starting point in computing “book” income is the initial “book” value of contributed property – the fair market value at time of contribution. Future taxable income and taxable loss reflect adjustments to the tax basis in the property. Future “book” income and “book” loss reflect adjustments to the “book” value in the property. “Book” income and “book” loss are computed in accordance with normal tax principles, except that “book” income and “book” loss use the adjusted “book” value of partnership property rather than its adjusted tax basis. “Book” depreciation is based on tax principles of cost recovery, except that the applicable factors are applied to adjusted “book” value (starting with date of contribution fair market value) rather than adjusted tax basis. “Book” gain on sale is computed based on adjusted “book” value rather than on adjusted tax basis.\textsuperscript{508}

60. Definitions.

Consolidate definitions in one place in your partnership agreement. Definitions may be consolidated in an article early in your partnership agreement or in an attachment. Another common arrangement is to provide for non-tax definitions

\textsuperscript{507} Drafting “book” allocations is discussed in the text below beginning at note 581.

\textsuperscript{508} Treas. Reg. § 1.704-1(b)(2)(iv)(g)(3) (“The partners’ capital accounts will not be considered adjusted in accordance with this paragraph (b)(2)(iv)(g) unless the amount of book depreciation, depletion, or amortization for a period with respect to an item of partnership property is the amount that bears the same relationship to the book value of such property as the depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to such property for such period bears to the adjusted tax basis of such property. If such property has a zero adjusted tax basis, the book depreciation, depletion, or amortization may be determined under any reasonable method selected by the partnership.”).
to be included in a section of the partnership agreement and tax-oriented definitions to be included in an attachment. Any of these methods is satisfactory.

Some terms in your partnership agreement will be tax-oriented (for example, definitions of “minimum gain” or “capital account”). Consider defining tax-oriented terms by reference to Treasury Regulations. This avoids long, cumbersome definitions in the text of your partnership agreement. (Many partnership agreements are burdened by long, complex definitions that intimidate readers and that readers just skim and do not read.) Inexperienced draftsmen – sometimes even experienced draftsmen – fail properly to reflect the full nuance of tax terminology when defining terms in detail in their partnership agreements.

A popular way to define terms details the definition of a term (typically, in language differing from the language in the definition in Treasury Regulations) and then says that the definition is to be interpreted consistently with the corresponding term defined in Treasury Regulations. What is this supposed to mean? Say that the term in your partnership agreement is defined in Treasury Regulations if that is what you mean. There may be a disparity between the definition in your partnership agreement and the definition in Treasury Regulations if you do not clearly incorporate the definition in Treasury Regulations. Either quote a definition verbatim or incorporate the definition by cross-reference if you want to use the definition in Treasury Regulations. (Even if you copy the language in the Treasury Regulation for a definition, it may not have the same gloss that the Treasury Regulation does, unless you also say that the meaning is in accordance with the Treasury Regulation. Consider incorporating the Treasury Regulation by cross reference. Copying the language in the Treasury Regulation for a definition may not pick up amendments to the Treasury Regulations.) A definition that uses language that differs materially from the language of Treasury Regulations creates the possibility that the definition may not be interpreted in accordance with the terms set forth in Treasury Regulations, regardless of an injunction that terms be interpreted consistently with the term in Treasury Regulations.

Some key tax definitions are useful.

a. **Capital Account.**

“Capital Account” of a Partner means the capital account of that Partner determined from the inception of the Partnership strictly in accordance with the rules set forth in Section 1.704-1(b)(2)(iv) of the Treasury Regulations.

Or:

“Capital Account” of a Partner means the capital account of that Partner determined from the inception of the Partnership strictly in accordance with the rules set forth in Section 1.704-1(b)(2)(iv) of the Treas-
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Capital accounts are fundamental to partnership economics. The proposed definitions of “capital account” precisely follow Treasury Regulations concerning capital account maintenance. Capital accounts are a book value to which the definition of “Capital Account” refers, normally the adjusted tax basis of a partnership asset. The fair market value of a partnership asset is determined by valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.509 Partners’ determinations of fair market value are not accepted automatically. The partners’ determination is acceptable only if they agree to among the partners in arm’s-length negotiations, and the partners have sufficiently adverse interests.” Id. Treasury Regulations do not clarify their requirement of “arm’s-length

509 Treas. Reg. § 1.704-1(b)(2)(iv). For a more detailed discussion of capital accounts, see material in text at note 787.

510 Treas. Reg. § 1.704-1(b)(2)(iv)(h) (“Determinations of fair market value. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm’s-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.”). Partners’ determinations of fair market value are not accepted automatically. The partners’ determination is accepted only if “(1) such value is reasonably agreed to among the partners in arm’s-length negotiations, and (2) the partners have sufficiently adverse interests.” Id. Treasury Regulations do not clarify their requirement of “arm’s-length
the asset (adjusted by depreciation) is the “book” value when the asset was contributed by a partner (or receives an adjusted “book” value on account of a permitted revaluation). A disparity may exist between “book” income and taxable in-

negotiations” and how partners must establish these “arm’s-length negotiations.” In addition to showing arm’s-length negotiations, the partners must show that the values are reasonable. It should be possible in some cases for values to be reached in arm’s-length negotiations and not to be reasonable. The valuation agreed to by the partners then is not used for purposes of Treasury Regulations on capital account maintenance. Even where values are reasonable and are reached in arm’s-length negotiations, the value agreed to by the partners is presumed correct only if the partners are able to establish that they have sufficiently adverse interests. This presumably means that the interests must be adverse as to the valuation. Draftsmen of family partnership agreements should pay particular attention to the limitations of Treas. Reg. § 1.704-1(b)(2)(iv)(h). The rejection by the IRS of values used by the partners in establishing capital accounts could have profound implications for the partners and the partnership.


(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

come. Capital accounts are increased by “book” income rather than by taxable income when a disparity exists between “book” income and taxable income. Capital accounts similarly are decreased by “book” loss and not by tax loss when a disparity exists between “book” loss and taxable loss. This convention acknowledges that capital accounts already reflect the built-in appreciation or depreciation of an asset that exists at time of contribution. Capital accounts have been adjusted for built-in appreciation or depreciation of an asset that exists at time of revaluation.

The more formal definition of “capital account” goes on for pages in Treasury Regulations. Few draftsmen capture all of the nuances of the definition of “capital account” in an extensive descriptive definition.

Some partnership agreements provide for the general partner or manager to make changes to capital accounts in order to conform to requirements of Treasury Regulations. The tax effects of those provisions are uncertain. These changes should not be necessary if your partnership agreement is well-drafted. Consider the possibility that this discretion could be abused. Consider defining “capital accounts” in accordance with Treasury Regulations in order to avoid the necessity of those adjustments.

Many partnership agreements provide much more complicated definitions of “Capital Account.” Accountants may not read such complicated definitions in interpreting your partnership agreement. Whether those more detailed definitions add anything to the definition obtained by cross-referencing the capital account maintenance rules in Treasury Regulations is unresolved.

A partner contributes real property to your partnership. The property has a basis of $2 million and a fair market value at time of contribution of $5 million. The $5 million fair market value of the real property is credited to the contributing partner’s capital account. The difference between the $5 million fair market value and the $2 million adjusted tax basis is credited to the contributing partner’s capital account (measured at the time of his admission to your partnership). Your partnership computes its future taxable income based on the $2 million adjusted tax basis of the real property (as adjusted by future depreciation). Your partner-


512 See discussion of “capital account” below at note 787. See also note 511.

513 See further discussion of Capital Accounts below at note 787. See also note 511.
ship would recognize roughly $3 million in taxable gain if it sold the contributed property promptly after contribution. This gain will be specially allocated to the contributing partner under the tax rules (Section 704(c)(1)(A)) that apply to contributed property with a “book”-tax disparity.\textsuperscript{514} The contributing partner would have a capital account of $8 million if his initial capital account of $5 million were increased by this $3 million of gain. That would make no economic sense at all. The proposed definition of “Capital Account” (incorporating the definition in the Treasury Regulations) avoids this double counting. Capital Accounts are adjusted by “book” income ($0) and not by taxable income ($3 million).

b. \textbf{Adjusted Capital Account.}

“Adjusted Capital Account” means (with respect to any Partner) the balance (if any) in the Partner’s Capital Account, increased by any potential income allocable to the Partner under the Minimum Gain Chargeback and the Partner Nonrecourse Debt Minimum Gain Chargeback [and the Exculpatory Deduction Minimum Gain Chargeback].

Capital accounts will be increased when partnership minimum gain and partner nonrecourse deduction minimum gain is recognized. This latent gain is built into the deal. Some partnership agreements use Adjusted Capital Account to reflect the partner’s capital account, adjusted for potential income under the minimum gain chargeback and partner nonrecourse debt minimum gain chargeback. “Adjusted Capital Account” recalls the latency of those minimum gain chargeback and partner minimum gain chargeback allocations. If the partnership agreement contains an exculpatory deduction minimum gain chargeback, a good case can be made the Adjusted Capital Account should be adjusted by potential gain allocable under that provision. “Adjusted Capital Account” is useful in drafting partnership allocations. Consider drafting allocations with targets based on the partners’ Adjusted Capital Accounts rather than the partners’ Capital Accounts.

c. \textbf{Adjusted Capital Account Deficit.}

“Adjusted Capital Account Deficit” means (with respect to any Partner) the negative amount (if any) determined by starting with the Partner’s Capital Account and adjusting the Partner’s Capital Account under these rules:

(a) Increasing the Partner’s Capital Account by any amounts that the Partner is obligated to restore (under this Agreement or by operation of law) upon liquidation of the Partner’s Partnership Interest or is

\textsuperscript{514} I.R.C. § 704(c)(1)(A).
deemed to be obligated to restore (under Treasury Regulations Sections 1.704-2(g)(1) and 1.704-2(i)(5)); and

(b) Decreasing the Partner’s Capital Account by the items described in Treasury Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5) and (6).

A partner’s share of exculpatory deductions\(^{515}\) perhaps should create a deemed capital account restoration obligation, but that is not what the Treasury Regulations currently provide.

Some partnership agreements use Adjusted Capital Account Deficit to reflect the partner’s capital account, adjusted as required for purposes of the qualified income offset and for potential income under the minimum gain chargeback and partner nonrecourse debt minimum gain chargeback. Adjusted Capital Account Deficit is useful in drafting a limit on loss allocations under the alternate test for economic effect.\(^{516}\) Loss allocations to a partner are permitted under the alternate test for economic effect so long as the partner does not have an Adjusted Capital Account Deficit. (Adjusted Capital Account Deficit is negative or zero.) The positive adjustments reflect shares of minimum gain and partner nonrecourse debt minimum gain. The downward adjustments are adjustments from the alternate test of economic effect.

d. Adjusted Capital Contribution.

“Adjusted Capital Contribution”\(^{517}\) means the excess of (i) the Capital Contribution of the Partner to the Partnership (including Capital Contributions credited to the Partner and made by that Partner’s predecessors in interest with respect to the Partnership Interest held by the Partner) over (ii) all Distributions to the Partner (or to the Partner’s predecessors in interest with respect to the Partnership Interest held by the Partner) under Section x.x.

The Adjusted Capital Contribution represents the unreturned capital contribution of a partner. You need to be careful in determining what distributions reduce Adjusted Capital Contribution. You also need to be careful in considering contributions made by and distributions made to the partner’s predecessors in interest when the partner has acquired the Partnership Interest by transfer.

\(^{515}\) See discussion in text accompanying notes 540 and 900.

\(^{516}\) See discussion in text accompanying note 1040.

\(^{517}\) Sometimes this is Cash Available for Distribution or Available Cash or Cash Flow.
e. Distributable Cash.

“Distributable Cash”\(^{518}\) means the cash in hand or in Partnership bank accounts that the General Partner deems is available for distribution to the Partners. Distributable Cash is determined after considering the current needs of the Partnership business and after establishing adequate reserves for contingencies and budgeted expenses.

This simple definition works fine if limited partners trust the general partner to be diligent in making cash distributions.

This is another simple definition of Distributable Cash:

“Distributable Cash” means all cash funds (including (without prejudice to generality) interest received on reserves) of the Partnership (but not Capital Proceeds) without reduction for any noncash charges, but less cash funds used to pay current operating expenses (including (without prejudice to generality) debt service) and to establish reasonable reserves for future expenses, debt payments, capital improvements, and replacements (as determined by the General Partner in his sole and absolute discretion).

Distributable Cash can be defined:

“Distributable Cash” means the excess of –

(a) The Partnership cash then in hand or in bank accounts of the Partnership over

(b) The sum of –

(i) The cash required for the payment of all current expenses, liabilities and obligations of the Partnership (whether for expense items, capital expenditures, improvements, retirement of indebtedness or otherwise) (as determined in the sole and absolute discretion of the General Partner), and

(ii) The reserves established (in the sole and absolute discretion of the General Partner) for the payment of future Partnership capital expenditures, improvements, retirements of indebtedness, operations and contingencies. This includes amounts known or unknown, liquidated or unliquidated, and liabilities that may be incurred in litigation and liabilities undertaken under the indemnification provisions of this Agreement.

\(^{518}\) Sometimes this is Cash Available for Distribution or Available Cash or Cash Flow.
Some partnership agreements use much more complicated definitions of Distributable Cash. This is a formula definition of “Distributable Cash”:

“Distributable Cash” means (with respect to any period for which the calculation is being made) means:

(a) The sum (without duplication) of:
   (i) The Partnership’s Net Profits or Net Loss (as the case may be) for the period;
   (ii) Depreciation and all other noncash charges to the extent deducted in determining Net Profits or Net Loss for the period;
   (iii) The amount of any reduction in the reserves of the Partnership referred to in clause (b)(vi) below (including (without prejudice to generality) reductions resulting because the General Partner determines these amounts are no longer necessary);
   (iv) The excess (if any) of –
      (A) The net cash proceeds from the sale, exchange, disposition, financing or refinancing of Partnership property for the period over
      (B) The gain (or loss, as the case may be) recognized from the sale, exchange, disposition, financing or refinancing during the period (excluding Terminating Capital Transactions); and
   (v) All other cash received by the Partnership for the period that was not included in determining Net Profits or Net Loss (or the special allocations referred to in clause (a)(i)) for the period (except Capital Contributions made in cash);

(b) Less the sum (without duplication) of:
   (i) All principal and debt related payments not deducted in determining Net Profits or Net Loss (or the special allocations referred to in clause (a)(i)) made by the Partnership during the period;
   (ii) Capital expenditures made by the Partnership during the period;
   (iii) Investments in any entity (including (without prejudice to generality) loans made to any entity) to the extent that the investments are not otherwise described in clause (b)(i) or (b)(ii);
   (iv) All other expenditures and payments not deducted in determining Net Profits or Net Loss (or the special allocations referred to in clause (a)(i)) for the period;
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(v) Any amount included in determining Net Profits or Net Loss (or the special allocations referred to in clause (a)(i)) for the period that was not received by the Partnership during the period;

(vi) The amount of any increase in reserves during the period that the General Partner determines to be necessary or appropriate (in its sole and absolute discretion); and

(vii) The amount of any working capital accounts and other cash or similar balances that the General Partner determines to be necessary or appropriate (in its sole and absolute discretion).

Notwithstanding the foregoing, Distributable Cash shall not include –

(c) Any cash received or reductions in reserves, or take into account any disbursements made or reserves established, after dissolution and the commencement of the liquidation and winding up of the Partnership; or

(d) Any Capital Contributions (whenever received).

This definition is long and complicated. This definition is much more than is necessary for most partnerships. This more detailed definition can be useful if the limited investors distrust the general partner or the manager and desire an objective standard that can be used to force the general partner to distribute Distributable Cash. Realize that the establishment of reserves may be subject to considerable differences in judgment.

Distributable Cash is an important concept. Distributable Cash is the cash that is available for distribution to the partners.\(^519\) Distributable Cash may be defined fairly simply as above or by a more detailed formula. The definition of “Distributable Cash” set forth above at the beginning of this section is a simple, compact, but utilitarian definition.

Some partnership agreements have separate provisions for distributions from partnership operations versus distributions from partnership capital events. Be careful to consider the possibility that the partnership’s cash flow may come

\(^{519}\) Distributable Cash may be subdivided into distributable cash from operations, distributable cash from sale of partnership assets, and distributable cash from financings or refinancings. In some partnership agreements, there are many more divisions of Distributable Cash. For example, there might be a separate scheme or set of schemes for distributing Distributable Cash for each series of a series partnership. The concept of series partnership is discussed in the text accompanying note 731.
from a subsidiary partnership or from a single member limited liability company. This requires careful drafting.

f. **Nonrecourse Liability.**

“Nonrecourse Liability” means a liability treated as a “nonrecourse liability” under Sections 1.704-2(b)(3) and 1.752-1(a)(2) of the Treasury Regulations.

A “nonrecourse liability” for purposes of partnership allocations is a liability with respect to which none of the partners (or an affiliate) bears the economic risk of loss.\(^{520}\)

A partner bears the economic risk of loss of a partnership liability, in general, to the extent that, if the partnership liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner. All of these events are treated as occurring simultaneously upon a constructive liquidation:

- All of the partnership’s liabilities become payable in full;
- With the exception of property contributed to secure a partnership liability, all of the partnership’s assets (including cash) have a value of zero;
- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deduction are allocated among the partners; and
- The partnership liquidates.\(^{521}\)

---

\(^{520}\) More formally, Treasury Regulations say: “Nonrecourse Liability” means “a nonrecourse liability as defined in section 1.752-1(a)(2) or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after June 24, 2003.” Treas. Reg. § 1.704-2(b)(3). Treasury Regulations provide: “A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under section 1.752-2.” Treas. Reg. § 1.752-1(b)(2).

\(^{521}\) Treas. Reg. § 1.752-2(b)(1).
g. Partnership Minimum Gain.

“Partnership Minimum Gain” with respect to Fiscal Year of the Partnership means the “partnership minimum gain” of the Partnership computed in accordance with Section 1.704-1(b)(2) and Section 1.704-2(d) of the Treasury Regulations.

The minimum gain (or Partnership Minimum Gain) equals nonrecourse liabilities over “book” value of the security (regardless of the fair market value of the security). This represents the minimum amount that would be recognized on a foreclosure of the nonrecourse liabilities. Partnership Minimum Gain is a “book” concept and not purely a tax concept. Partnership Minimum Gain is important in defining nonrecourse deductions and the minimum gain chargeback.

The “book” value is normally the adjusted tax basis of a partnership asset; however, the fair market value of the asset (adjusted by depreciation) is the “book” value when the asset was contributed by a partner (or receives an adjusted “book” value on account of a permitted revaluation).

The minimum gain chargeback cannot be overridden, regardless of what your partnership agreement says. The minimum gain chargeback will still apply when the property is sold, even when your partnership agreement previously charged back nonrecourse deduction allocations with allocations of operating income. A double chargeback of minimum gain will distort partnership economics and can result in the recipient of the double chargeback receiving more cash on liquidation of the partnership than the partners intend. The solution is not to draft operating income allocations that charge back nonrecourse deductions. Learning to draft effectively with the minimum gain chargeback and nonrecourse deductions, see text accompanying note 847.

h. Partner Nonrecourse Debt.

“Partner Nonrecourse Debt” means any “partner nonrecourse liability” or “partner nonrecourse debt” as determined under Section 1.704-2(b)(4) of the Treasury Regulations.

---

522 See discussion of “book” items in text accompanying note 505.
525 For more detailed consideration of the minimum gain chargeback and nonrecourse deductions, see text accompanying note 847.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Partner nonrecourse liability or Partner Nonrecourse Debt generally is a partnership liability that is nonrecourse to your partnership, but a partner or related person is the lender, creditor, or guarantor.\(^{526}\)

i. Partner Nonrecourse Debt Minimum Gain.

“Partner Nonrecourse Debt Minimum Gain” means “partner nonrecourse debt minimum gain” computed in accordance with Section 1.704-2(i)(2) of the Treasury Regulations.

Partner nonrecourse debt minimum gain (or Partner Nonrecourse Debt Minimum Gain) is a tax concept. This refers to the excess of partner nonrecourse debt over the adjusted tax basis (or “book” value) of the security for this debt. The Partner Nonrecourse Debt Minimum Gain is the minimum amount that would be recognized on a foreclosure of the Partner Nonrecourse Debt. “Book” value rather than adjusted tax basis is used for computing Partner Nonrecourse Debt Minimum Gain if the two differ. Partner Nonrecourse Debt Minimum Gain is a “book” concept and not purely a tax concept. Partner Nonrecourse Debt Minimum Gain is important in defining partner nonrecourse deductions and the minimum gain chargeback.\(^{527}\)

j. Exculpatory Liability.

“Exculpatory Liabilities” are liabilities of the Partnership that are not recourse to any Partner but that do not produce “partnership minimum gain” under Treasury Regulations Section 1.704-2(d)(1).

Exculpatory liabilities include liabilities that are not secured by any specific property and that are recourse to the Partnership as an entity, but explicitly not recourse to any partner. These exculpatory liabilities are described in more detail in the text accompanying note 900.

\(^{526}\) For more detailed consideration of partner nonrecourse debt and partner nonrecourse deductions, see text accompanying note 888. Treasury Regulations more formally provide: “‘Partner nonrecourse debt’ or ‘partner nonrecourse liability’ means any partnership liability to the extent the liability is nonrecourse for purposes of section 1.1001-2, and a partner or related person (within the meaning of section 1.752-4(b)) bears the economic risk of loss – under section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.” Treas. Reg. § 1.704-2(b)(4).

\(^{527}\) For more detailed consideration of partner nonrecourse debt and partner nonrecourse deductions, see text accompanying note 888.
k. Exculpatory Liability Minimum Gain.

“Exculpatory Liability Minimum Gain” of the Company shall mean the “minimum gain” of the Partnership (computed in accordance with the principles of Treasury Regulations Section 1.704-2(d)) computed by considering only Exculpatory Liabilities and computed as if Exculpatory Liabilities were “nonrecourse liabilities” encumbering all assets of the Partnership that may be reached by a creditor of the Partnership with respect to these Exculpatory Liabilities.

Exculpatory Liability Minimum Gain is minimum gain computed by considering only Exculpatory Liabilities. This concept is discussed in more detail in the text accompanying note 900.

l. Net Profits and Net Losses.

“Net Profits” and “Net Losses” mean, for each Fiscal Period of the Partnership, the net income or net loss, respectively, of the Partnership. For this purpose, “income” shall refer to all tax items (other than Contributions) that increase capital accounts under Treasury Regulations Section 1.704-1(b)(2)(iv), and “loss” shall refer to all tax items (other than Distributions) that decrease capital accounts under Treasury Regulations Section 1.704-1(b)(2)(iv). Notwithstanding the foregoing, these items shall be excluded from the computation of Net Profits and Net Losses:

- Any gain, income, deductions or losses specially allocated under the Minimum Gain Chargeback, Partner Nonrecourse Debt Minimum Gain Chargeback, [Exculpatory Liability Minimum Gain Chargeback], and Qualified Income Offset;
- Any Nonrecourse Deductions;
- Any Partner Nonrecourse Deductions; and
- Any Exculpatory Deductions. 528

These rules shall apply when assets of the Partnership include partnership interests (collectively, “Partnership Interests”) in subsidiary partnerships or subsidiary limited liability companies (collectively, “Tax Partnerships”) (as the case may be):

- There may be a difference between the Partnership’s agreed “book” value and adjusted tax basis in any of these Partnership Interests.

---

528 See discussion in text accompanying notes 540 and 900.
(f) There also may be a corresponding difference between the Partnership’s “book” value in the Partnership Interest and the Tax Partnership’s “book” value in its assets.

(g) With respect to any Partnership Interest with a “book”-tax disparity, the “book” value of the Partnership Interest shall be treated as the “book” value of the assets of the Tax Partnership and shall be applied to redetermine the “book” values of the assets of any indirect subsidiary Tax Partnership for purposes of determining the “book” income and “book” losses and the Net Profits and Net Losses of the Partnership.

(h) The Manager shall be responsible for reasonably allocating the “book” value of each Partnership Interest to the assets of that Tax Partnership and to the assets of any indirect subsidiary Tax Partnership in redetermining the “book” values of the Tax Partnership and any indirect subsidiary Tax Partnership.

(i) These redetermined “book” values shall be used for the determination of “book” income and “book” losses of the Partnership and Net Profits and Net Losses.

(j) For this purpose, “book” shall have the meaning ascribed to that term in Treasury Regulations Section 1.704-1(b)(2)(iv).

This is another common form of definition of Net Profits and Net Losses:

“Net Profits” and “Net Losses” means (for each Fiscal Year of the Company (or other period for which Net Profits or Net Losses must be computed)) the Company’s net taxable income or net taxable loss determined in accordance with Code Section 703(a), with the following adjustments (without duplication):

(a) All items of income, gain, loss, deduction, or credit required to be stated separately under Code Section 703(a)(1) shall be included in computing taxable income or loss;

(b) Any tax-exempt income of the Company (not otherwise taken into account in computing Net Profits or Net Losses) shall be included in computing taxable income or loss;

(c) Any expenditures of the Company described in Code Section 705(a)(2)(B) (or treated as such under Treasury Regulations Section 1.704-1(b)(2)(iv)(i)) (and not otherwise taken into account in computing Net Profits or Net Losses) shall be subtracted from taxable income or loss;

(d) Gain or loss resulting from any taxable disposition of Company property shall be computed by reference to the adjusted book
value of the property disposed of, notwithstanding the fact that the adjusted book value differs from the adjusted basis of the property for federal income tax purposes;

(e) Depreciation computed based upon the adjusted book value of the asset (as determined in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv)) shall be taken into account in lieu of the depreciation, amortization, or cost recovery deductions allowable in computing taxable income or loss; and

(f) Notwithstanding any other provision of this definition, any items that are specially allocated under Sections * * * shall not be taken into account in computing Net Profits or Net Losses.

Other partnership agreements can spend page after page defining “Net Profits” and “Net Losses” and subordinate terms included in their definitions. This increases the bulk of the partnership agreements and often reduces readers’ ability to understand them.

Your partnership agreement might exclude exculpatory deductions from the computation of Net Profits and Net Losses. Exculpatory deductions might be allocated separately or they might (with care) be allocated as part of “Nonrecourse Deductions” (even though there is considerable doubt that exculpatory deductions are nonrecourse deductions under the Treasury Regulations and there is doubt that exculpatory deductions produce partnership minimum gain).

My partnership agreements often allocate Net Profits and Net Losses. These terms reflect net “book” income and net “book” loss. Net Profits and Net Losses adjust net “book” income and net “book” loss. The definitions exclude from the computation of Net Profits and Net Losses any specially allocated items. This exclusion ensures that these items not be allocated under two different provisions of your partnership agreement. Net Profits are computed without considering nonrecourse deductions, partner recourse deductions, specially allocated loss items, and items allocated under the minimum gain chargeback, partner nonrecourse debt minimum gain chargeback, and qualified income offset. Exclude gains or losses from the sale of partnership capital assets from the computation of Net Profits and Net Losses if those gains and losses are specially allocated under another paragraph in your partnership agreement.

---

529 See discussion in text accompanying notes 540 and 900.
530 Other partnership agreements may embed similar concepts in the terms “Income” and “Loss.”
531 See discussion of “book” items in text accompanying note 505.
Net Profits and Net Losses permit you to draft a cleaner agreement without special overrides for “regulatory allocations” (for example, the minimum gain chargeback). This avoids the possibility that an item of income or loss is allocated in different ways under two different provisions of your partnership agreement.

The second proposed definition of “Net Profits” and “Net Losses” addresses the possibility that income or loss may be passed through from a subsidiary partnership. Treasury Regulations (and most partnership agreements) do not do a particularly good job of addressing the computation of “book” income and “book” loss when “book” income and “book” loss flow through from a subsidiary partnership. Treasury Regulations usually work well enough except when a disparity exists between your partnership’s “book” value in a subsidiary partnership interest and the adjusted tax basis in the subsidiary partnership interest. This often results from the contribution of a subsidiary partnership interest to the partnership or an adjustment to the “book” values of partnership interest (for example, on account of certain contributions to the partnership or distributions from the partnership).

Some partnership agreements allocate gross income and gross deductions. These partnership agreements often are difficult to draft and difficult to use. Consider allocating net income and net losses rather than gross items of income and loss. Carefully define these concepts.

Some agreements allocate net income and net losses as computed in accordance with Generally Accepted Accounting Principles. This is fine. Allocating GAAP income and loss requires allocating taxable income and taxable loss by adjusting entries.

Other agreements allocate net taxable income and net taxable losses. These agreements often fail when they address property contributed with a “book”-tax disparity (Section 704(c)(1)(A)). Income and loss attributable to this “book”-tax disparity is allocated automatically under a special Code provision (Section 704(c)(1)(A)).

Consider drafting your partnership agreement to allocate net income and net loss as computed in accordance with Treasury Regulations governing capital accounts.

---

532 Tiered partnerships are addressed in the nonrecourse deduction Treasury Regulations. See Treas. Reg. § 1.704-2(k).
533 Treas. Reg. § 1.704-1(b)(2)(iv)(f), (g).
534 Treas. Reg. § 1.704-1(b)(2)(iv). This technique excludes from net income and net losses those items that are specially allocated under the rules of I.R.C. (footnote continued on the next page)
as “book” income and “book” loss, respectively. A carefully drafted partnership agreement might adjust “book” income and “book” loss by excluding items that are allocated under special allocations provisions (for example, the minimum gain chargeback, partner nonrecourse debt minimum gain chargeback, nonrecourse deductions, partner nonrecourse deductions, and other special allocation provisions). These adjustments will help to avoid allocating the same dollar or income under two different provisions in your partnership agreement.

Agreed fair market value of assets contributed to the partnership by partners often differs from adjusted tax basis. Treasury Regulations start capital accounts at the fair market value of contributed assets. “Book” income and “book” loss are based on accounting starting with fair market values of property as initial “book” value and adjusting this “book” value by depreciation computed under federal income tax principles. “Book” income and “book” loss ignore true taxable income and taxable loss when a “book”-tax disparity exists. Income or loss attributable to this “book”-tax disparity is allocated automatically under a special Code provision (Section 704(c)(1)(A)).

m. **Nonrecourse Deductions.**

“Nonrecourse Deductions” in any Fiscal Period mean the amount of Partnership deductions that are characterized as “nonrecourse deductions” under Section 1.704-2(b) of the Treasury Regulations.

Nonrecourse Deductions are deductions attributable to nonrecourse liabilities. These deductions correspond to the annual increase of nonrecourse liabilities over the “book” value of the security. Nonrecourse Deductions are a “book” concept and not purely a tax concept.

Your definition of Nonrecourse Deductions might be expanded to include exculpatory deductions as Nonrecourse Deductions as a matter of convenience. Be careful if you do so. Partnership case law, statutory law and administrative law are unclear on whether exculpatory deductions technically are nonrecourse deductions. The better practice is to exclude exculpatory deductions from Net Profits, § 704(c)(1)(A) that apply to built-in gain and losses at the time property is contributed to the partnership.

---

536 On nonrecourse deductions generally, see discussion in text accompanying note 599; Terence Floyd Cuff, “Some Nuances of Partnership Nonrecourse Deductions,” from Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006.
537 See discussion in text accompanying notes 540 and 900.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Net Losses, and Nonrecourse deductions. Provide a separate provision in your partnership agreement that allocates exculpatory deductions (perhaps in accordance with bottom line percentage interests). 538

n. Partner Nonrecourse Deductions.

“Partner Nonrecourse Deductions” mean “partner nonrecourse deductions” (determined under Section 1.704-2(i) of the Treasury Regulations).

Partner nonrecourse deductions (or Partner Nonrecourse Deductions) are parallel to nonrecourse deductions, except that partner nonrecourse deductions pertain to partner nonrecourse debt. Partner nonrecourse deductions are equal to the annual increase in partner nonrecourse debt over the “book” value of the security. Partner nonrecourse deductions often are created by depreciation. Partner Nonrecourse Deductions are a “book” concept and not purely a tax concept. 539

538 Treasury Regulations clarify “nonrecourse deductions”: “The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section). . . . However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a pro rata portion of other partnership losses, deductions, and Section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over.” Treas. Reg. § 1.704-2(c).

539 See discussion of “book” items in text accompanying note 9. More formally, Treasury Regulations provide: “Partnership losses, deductions, or Section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (‘partner nonrecourse deductions,’ as defined in paragraph (i)(2) of this section) must be allocated to the partner that bears the economic risk of loss for the liability. If more than one partner bears the economic risk of loss for a partner nonrecourse liability, any partner nonrecourse deductions attributable to that liability must be allocated among the partners according to the ratio in which they bear the economic risk of loss. If partners bear the economic risk of loss for different portions of a liability, each portion is treated as a separate partner nonrecourse liability. . . . For any partnership taxable year, the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals the net in-

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

o. Exculpatory Deductions.

“Exculpatory Deductions” are deductions of the Partnership that do not create “partnership minimum gain” (as used in Treasury Regulations Section 1.704-2(d)) or “partner nonrecourse debt minimum gain” (as used in Treasury Regulations Section 1.704-2(i)) but that are attributable to liabilities of the Partnership that are without recourse to any Partner or Affiliate of a Partner.

Exculpatory deductions include deductions created by liabilities that are full recourse to the partnership but nonrecourse to all partners and their affiliates. Exculpatory deductions also should include deductions created by liabilities that increase during the year in minimum gain attributable to the partner nonrecourse debt (‘partner nonrecourse debt minimum gain’), reduced (but not below zero) by proceeds of the liability distributed during the year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. . . .” Treas. Reg. § 1.704-2(i)(1), (2).

See discussion in text accompanying note 900. The preamble to the Treasury Regulations on nonrecourse deductions provides this guidance:

A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. Under that definition, an exculpatory liability is a nonrecourse liability. The application of the nonrecourse debt rules of section 1.704-2 – more specifically, the calculation of minimum gain – may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached by the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b). Commentators have requested that the treatment of allocations attributable to exculpatory liabilities under the nonrecourse debt rules be clarified. The Service and the Treasury solicit further suggestions on the appropriate treatment of allocations attributable to these liabilities. Suggestions should take into account the practical concerns of partnerships as well as (footnote continued on the next page)
ties that are recourse to a subset of partnership assets but nonrecourse to the partners and their affiliates (but that do not produce minimum gain). These exculpatory deductions might include deductions created by liabilities that are full recourse to a special purpose limited liability subsidiary of a partnership but nonrecourse to the partnership or its partners (or their affiliates). The preamble to Treasury Regulations on nonrecourse deductions identify as “exculpatory deductions” merely these deductions attributable to unsecured liabilities, but that is too limited: “a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability).” The identifying signature of an exculpatory is that no partner nor affiliate has any liability (including liability as a guarantor) and the liability does not create minimum gain.

Exculpatory deductions also are “book” deductions. This definition should be used with care, since it is not entirely clear from the Treasury Regulations precisely what deductions are exculpatory deductions. The concept of exculpatory deductions is discussed in more detail in the text accompanying note 900.

61. Cash Distributions.

Section x.x Distribution of Distributable Cash. The Partnership shall distribute Distributable Cash to the Partners in this order of priority. The test in each subsection shall be reapplied (independent of prior satisfaction of this test) whenever a distribution is made:

(a) First, the Partnership shall distribute Distributable Cash to the Partners in proportion to their respective amounts of Undistributed Preferred Return. Distributions shall continue to be made under this Section x.x(a) while the Undistributed Preferred Return of one or more Partners is greater than zero (0).

(b) Second, the Partnership shall distribute the balance (if any) of Distributable Cash twenty-five percent (25%) to Partner 1 and seventy-five percent (75%) to Partner 2.

the Service’s concerns about the proper allocation of loss and gain items attributable to these liabilities.

Treasury Decision 8385, 56 FR 66978-66995 (December 27, 1991). Exculpatory deductions are further discussed in the text accompanying note 371.

541 Treasury Decision 8385, 56 FR 66978-66995 (December 27, 1991).

542 See discussion of “book” items in text accompanying note 505.
Another related provision might address form of partnership distributions:

Section x.x. Form of Distribution. No Partner has the right to demand or to receive any Distribution from the Partnership in any form other than money (regardless of the nature of the Partner’s Capital Contribution). The Partnership may not compel any Partner to accept a Distribution of any asset in kind (except upon a dissolution and the winding up of the Partnership).

Nothing is more critical to the economics of a partnership than the cash distribution provisions in your partnership agreement. Run many numerical examples to ensure that cash distribution provisions work as these provisions are intended to work.

Partnership agreements typically set forth income and loss allocation provisions prior to provisions describing distributions. It is clearer to discuss cash distribution provisions before allocation provisions.

Cash distribution provisions can be as simple as a single set of percentages. These provisions may involve many tiers of distributions and computations as complex as internal rates of return. The mathematics of cash distribution provisions often are complicated, making it important to run numerical examples to ensure that the cash distribution provisions work satisfactorily in all events.

Many partnership agreements contain flaws in the cash distribution provisions. These agreements may result in inconvenient litigation.543

A comprehensive guide to drafting cash allocations is far beyond the scope of this Article. Some observations, however, may be useful.

Simple single-tier percentage distribution provisions are not difficult to draft (25% to Elvira; 75% to Rapunzel). Tiered distribution provisions require greater clarity. Clarify how distributions are divided between general and limited partners. Clarify how distributions are divided within each of these two groups so that the allocation to each partner is clear. Clarify how distributions are divided within any class of partners receiving a tier of distributions. Draft each of the distribution provisions to clarify how much is distributed under the tier. Draft each tier of the distribution provisions to clarify how the distributions under the tier are divided among partners.

Draftsmen often create ambiguity in their distribution provisions by overusing “until.” The first tier distribution provision might have been drafted: “(a) First, to the Partners in proportion to their respective amounts of Undistributed

543 See Interactivecorp. v. Vivendi Universal, S.A., C.A. No. 20260 (Delaware Chancery Court (July 6, 2004)).
Preferred Return, *until* the Undistributed Preferred Return of all Partners is no greater than zero (0).” This formulation can create ambiguity. Must the preferred return condition be retested in each subsequent year after the condition has once been satisfied? Is the condition, once satisfied, satisfied forever? Expressing the condition in terms of “while” is more appropriate for a tier than is reapplied each year. This often is a better formulation: “(a) First, while the Undistributed Preferred Return of any Partner is greater than zero (0), Distributable Cash shall be distributed to the Partners in proportion to their respective amounts of their Undistributed Preferred Returns.” Another approach is simply to provide that the tests in the various tiers of allocations are reapplied whenever a distribution is made.

Consider these comments when drafting cash flow distribution provisions:

- Separate income and loss allocations from cash flow distributions.
- Consider separating the cash flow distribution provision into three parts—operating cash flow, cash flow from capital events, and proceeds of liquidation.
- Coordinate drafting of preferred returns and similar items that may be paid from either operating cash flow, cash flow attributable to capital events, or proceeds of liquidation.
- Draft cash flow distribution provisions before drafting allocations of profits and loss.
- Provide for liquidation in accordance with capital accounts only if you are competent to do so.
- Ensure that each tier of distributions specifies not only how much cash flow to allocate under the tier, but also clearly states how cash flow under the tier is distributed among partners receiving distributions under the tier.
- Precisely define when contributions are treated as invested in the partnership and when distributions are treated as made to the partners if you have preferred returns or distributions based on internal rate of return.
- Consider special computational years.
- Consider the effects of contributions being made by partners on different dates or distributions being made to partners on different dates.
- Run numerical examples to ensure that your distribution provisions work.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Coordinate your work with your partnership accountants to ensure that these accountants can understand your distribution and allocation provisions.

a. Preferred Return.

Section x.x Distributable Cash. The Partnership shall distribute Distributable Cash in this order of priority. The test in each subsection to be reapplied (independent of prior satisfaction of this test) whenever a distribution is made:

(a) First, the Partnership shall distribute all Distributable Cash to Partner X. Distributions shall be made under this Section x.x(a) while the distribution of Distributable Cash that Partner X has received under this Section x.x(a) from the formation of the Partnership is less than the amount necessary to give Partner X the Partner X Preferred Return (determined solely by considering distributions of Distributable Cash under this Section x.x(a)).

* * * *

Or:

Section x.x Distributable Cash. The Partnership shall distribute Distributable Cash in this order of priority. The test in each subsection to be reapplied (independent of prior satisfaction of this test) whenever a distribution is made:

(a) First, the Partnership shall distribute Distributable Cash to the Partners with Unpaid Preferred Returns (among those Partners in accordance with the ratio of their Unpaid Preferred Returns). Distributions shall be made under this Section x.x(a) while any Partner has an Unpaid Preferred Return. . . .

* * * *

Unpaid Preferred Return could be defined:

The “Unpaid Preferred Return” of a Partner means the excess of –

(a) Preferred Return of this Partner; over

---

544 If you use “until” rather than “while,” clarify whether the tier is retested every year, or whether the test, once met, is treated as met forever.

545 If you use “until” rather than “while,” clarify whether the tier is retested every year, or whether the test, once met, is treated as met forever.
(b) The cumulative sum of distributions to the Partner under Section x.x(a) or Section y.y(a).

A separate definition could define the Partner X Preferred Return:

**The Partner X Preferred Return is equal to a return of 7% per annum on the varying balance of Partner X’s Unrecovered Capital from the formation of the Partnership. This return shall be computed on the basis of a notional computational year of 360 days and 30 day months. This return shall be cumulative. The 7% return rate shall be compounded monthly on the first day of each calendar month. For this purpose, these accounting conventions shall apply:**

(a) Contributions shall be treated as made in accordance with these rules:

(i) Contributions of money made in immediately available funds shall be treated as made on the date of actual receipt by the Partnership; or,

(ii) Contributions of money not paid in immediately available funds but made by cheque, shall be treated as made on the date when the funds from this cheque have been fully credited to Partnership’s bank account (without holds or other draw limitations); or,

(iii) Contributions made in property and not in money shall be treated as made on the date when the property has been delivered to the Partnership (either by delivery of possession or by delivery of a deed or bill of sale or other instrument of conveyance).

(b) Distributions shall be treated as made in accordance with these rules:

(i) Distributions of money made in immediately available funds shall be treated as made on the date of actual payment by the Partnership; or,

(ii) Distributions of money if not paid in immediately available funds and made by cheque shall be treated as made,

(1) On the date when the Partnership has delivered the cheque to the Distributee in person, if the cheque is delivered by the Partnership to the Distributee in person,

(2) On the date when the Partnership has deposited the cheque in the United States mail, properly addressed and with postage prepaid, if the cheque is sent by United States mail; or
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(3) On the date when the Partnership has deposited the cheque for delivery by an overnight courier service (with all necessary fees properly prepaid in full) if the cheque is sent by overnight courier service; or

(iii) Distributions made in property and not in money shall be treated as made on the date when the property has been delivered to the Distributee by the Partnership either by delivery of possession or by delivery of a deed or bill or sale or other instrument of conveyance; and

(c) Amounts shall not bear interest for the day contributed (for purposes of computing all preferred returns), but shall bear interest for the day paid.

This is another, simpler definition of Preferred Return:

“Preferred Return” means a return equal to fifteen percent (15%) per annum on the average daily balance of the Unrecovered Capital for each Partner during the period to which the Preferred Return relates. The return of each Partner commences on the date when the Partner makes its Capital Contribution. This return shall be determined on the basis of a computational year of three hundred sixty-five (365) or three hundred sixty-six (366) days (as the case may be). This return shall be computed for the actual number of days occurring and the period for which the Preferred Return is being determined. This return is cumulative. This return shall be compounded annually on January 1 of each year.

A more naïve, ambiguous provision could provide:

“Preferred Return” means a return equal to fifteen percent (15%) interest on the Unrecovered Capital for each Partner.

A common distribution provision contains a preferred percentage return on invested capital. Important points to clarify include—

- What contributions are included in invested capital?
- What distributions reduce invested capital?
- What distributions are treated as payments of the preferred return?
- On what date is capital treated as invested (including the question of whether the partnership agreement provides a common date when all capital is treated as contributed)?
- Is there a common date when all initial capital contributions are treated as made (for purposes of computing the preferred return)?
- On what date are distributions are treated as distributed?
- The interest rate of the return.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• Whether the return cumulates if insufficient funds are available to
  pay the return annually.
• Whether the return accrues if not enough free cash is available during
  the year to pay the preferred return.
• Whether the return compounds.
• How often the return compounds.
• On what date the return compounds.
• The computational year (for example, a deemed 360-day computational
  year of twelve 30-day computational months or a calendar year of
  365/366 days).
• Whether arrearages in the return are paid on liquidation if the arrearages
  are not paid currently out of cash from operations.
• Whether the preferred return, on liquidation, is preferred to distributions
  of capital or capital account to other partners.

These considerations are important to many partnership distribution provisions. Too many partnership agreements fail to address many of these issues.

Providing that all initial capital contributions are treated as made on a single date (even though the contributions of the various partners may be made on several different dates) can simplify computations for your partnership agreement (with corresponding economic effects). Be careful in selecting any convention. You can encourage late payments and you can distort partnership economics with an ill-advised convention. Similarly, you may provide for an agreed computational date when a subsequent capital contribution is made by the partners. Clarify whether returns are computed based on a calendar year or another computational year (for example, a 360-day year of 30-day months). Failure to specify a computational year should result in computations being made on a 360/6 day year if the accountants rigorously follow financial custom. This significantly complicates the computations (if the partnership accountants bother to pay attention to the correct interpretation of your partnership agreement). Accountants too often will use a simpler 360-day year of 30-day months and may introduce their own simplifying computational assumption regardless of what the partnership agreement says. Some partnership agreements assume that all cash flows occur on the first or last day of the partnership’s taxable year, or the first or last day of a quarter or a month. These computational conventions may have material effects on the results in appropriate circumstances. Clarify the computational conventions that you want than to adopt the default of letting the partnership accountant follow his whim.

Provide for a separate income allocation tier in the allocation of operating income (or perhaps also gain from sale) corresponding to this preferred return.
Provide a catch-up provision if the partnership sells assets before the partner receives an operating income allocation corresponding to the preferred return.

Avoid the inclination to say that “Net Profits shall be allocated exclusively to Partner X until Partner X has received a distribution of Distributable Cash equal to the Partner X Preferred Return.” This language may produce a result at variance with what the parties want. This language could produce allocations at variance with partnership economics. There can be difficult issues if the partnership has substantial net income but distributions are blocked. This language will allocate all net income to the partner receiving the preferred return until distributions are unblocked and the preferred return is satisfied with cash distributions. This could be what you want, but it typically is not. Partners are more likely to want net income allocated to satisfy the preferred return only to the extent of the accrued preferred return. Partners may want net income allocated to satisfy the preferred return only to the extent that the preferred return has been distributed. Income often is realized in a different computational period from distribution of the corresponding cash flow. There may be substantial income well in excess of the preferred return, while your partnership is withholding distribution of the Partner X Preferred Return on account of business needs. Partner X’s capital account can be swelled by an over-allocation of income if income is allocated to Partner X until he receives the full distribution of his preferred return. This can result in Partner X receiving much more cash on liquidation of your partnership than accords with the economic deal.

Consider drafting an allocation of income under the preferred return something like this: “While Partner X has received allocations of Net Profits under this Section x.x less than the Partner X Preferred Return, Net Profits shall be allocated exclusively to Partner X.”

Preferred returns sometimes are preferred to distribution of capital to other partners. These preferred returns generally will be treated in whole or in part as resulting in guaranteed payments or in shifts in capital to the recipient partner. 546

b. Internal Rate of Return.

Section x.x. Distributable Cash. The Partnership shall distribute Distributable Cash to the Partners in this order of priority. The test in each subsection shall be reapplied (independent of prior satisfaction of this test) whenever a distribution is made:

(a) First, all Distributable Cash shall be distributed to Partner X. Distributions shall be made under this Section x.x(a) while Partner X

546 See discussion in text accompanying note 573.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

has not received sufficient Distributions under this Section x.x(a) to give
Partner X an Internal Rate of Return equal to or greater than the Specified IRR. . . .

A distribution tier may be based on distributions achieving a defined internal rate of return on net invested cash. Provisions of this type often showcase drafting skills at their worst. 547

Few partnership agreements with distribution tiers based on internal rates of return computation are drafted with rigorous precision – although they may be drafted well enough to produce results that will satisfy the partners. Many draftsmen (and many clients) do not have a firm understanding of how internal rates of return work. Many draftsmen (and many clients) may rarely, if ever, have computed internal rates of return themselves. Drafting effective internal-rate-of-return tiers requires experience in computing internal rates of return.

Distribution provisions based on achieving specified internal rates of return require careful drafting. Good drafting requires:

- Careful expression of the mathematics of internal rate of return.
- Recognizing that a partner rarely will achieve precisely an x% internal rate of return. 548
- Clear designation of when contributions and distributions are treated as paid.

Inexperienced draftsmen should avoid internal rate of return provisions whenever possible. Inexperienced draftsmen easily can make mistakes. Even experienced draftsmen can make mistakes or leave ambiguities.

The internal rate of return implicitly assumes that all cash flow amounts bear interest as a rate equal to the internal rate of return through the period of the

547 On internal rate of return and drafting partnership allocations, see text at note 621. See, generally, Terence Floyd Cuff, “Present Value and Internal Rate of Return,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006. Internal rate of return is discussed in detail in most textbooks on finance.

548 For example, an additional $0.01 of cash distributed may take a partner from a 6.99997% internal rate return to a 7.00003% internal rate of return. A partner may never receive precisely a 7% internal rate of return. A tier defined in terms of “until X receives a 7% internal rate of return” may be problematic. X never may receive precisely a 7% internal rate of return. Consider: “until X receives an internal rate of return of 7% or greater.” Consider what happens if a partner falls above a specified return and later drops below that return.
investment. Many financial analysts may question the validity of internal rate of return as a useful index of the performance of an investment. The internal rate of return mathematically asks at what discount rate the sum of present values of investments equals the sum of the present values of the returns or distributions.

This has the effect of treating distributions as earning a rate of return equal to the internal rate of return. This often is not realistic. The investor is treated as reinvesting cash flow distributions at a rate of return equal to the internal rate of return. Internal rate of real can provide an unrealistic model if the investor reinvests cash flows at a return rate substantially different from the internal rate of return. Many financial analysts prefer to use modified internal rate of return as an index of the performance of an investment. This rate specifies an agreed notional rate of return for distributions after the distributions are distributed.

Some financial analysts suggest that internal rate of return is an inappropriate metric of performance when there is an irregular rate of inflation. The internal rate of return takes inflation into account only in the return rate and implicitly assumes a constant rate of inflation. Some financial analysts suggest that computations should be adjusted so that all computations are adjusted for inflation and involve constant value dollars. Another possible theoretical flaw in internal rate of return as a metric of performance is that internal rate of return produces a single discount rate that is used for all returns, regardless of timing. It often is appropriate to use different discount rates for discounting cash flows occurring at different times. This is not possible under the internal rate of return analysis. Furthermore, internal rate of return does not provide a ready mechanism for adjusting cash flows based on different degrees of risk. It may be appropriate to use a higher discount rate to discount high risk cash flows and a lower discount rate to discount low risk cash flows. An internal rate of return analysis obscures the different risk of different cash flows. Internal rates of return are often of little value in evaluating very short-term investments. Many partnership agreements provide for a simple compounded rate of return on invested capital rather than using the pure internal rate of return. Many businessmen, however, feel more comfortable with deals with tiers based on satisfaction of internal rate of return thresholds.

Proposing an economic deal based on internal rates of return may be a sign of the lack of financial sophistication of the person proposing the deal. It also may be the sign of a sharp operator who feels that he can fleece investors by using a mathematically sophisticated concept that his investors will not properly understand. Advisors representing investors investing in deals with economics defined by internal rate of return thresholds are cautioned carefully to counsel their clients so that they will understand the economics of the deal.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

These are common flaws in partnership agreement provisions based on internal rate of return:

- Failure to consider whether internal rate of return is an appropriate measure of partnership economic performance.
- Ambiguous formulas or failure to specify the formula for computing present values.
- Failure to specify compounding frequency.
- Failure to specify compounding dates.
- Failure to specify computational year.
- Failure to adjust target rate to a daily, monthly, or quarterly interest rate, when this is appropriate.
- Ambiguity of when contributions are treated as made and when distributions are treated as made.
- Failure to deal with multiple solutions to the internal rate of return equation.
- Failure to clarify whether once the internal rate of return condition is satisfied it always is treated as satisfied, regardless of subsequent contributions of capital.
- Inadvertently including subsequent tier distributions in satisfying the internal rate of return conditions when capital contributions are made after the condition has been satisfied.
- Specifying as a condition that distributions must be “equal to” a specified return.
- Failure to draft acceptable allocations that implement the internal rate of return distribution provisions.
- An internal rate of return deal may make little sense for a long-term investment partnership. Internal rate of return targets will not be reached until capital has been fully returned (plus the specified return).
- Profits allocations can be difficult to draft with an internal rate of return deal if cash distributions are blocked by lender requirements or when cash is being reinvested to improve the project.

Ensure that you have experience computing internal rates of return and that you fully understand the mathematical concepts. Drafting partnership allocations based on internal rates of return is difficult if you do not fully understand the mathematics of internal rate of return. Only through computational practice will you fully understand the drafting nuances.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Start with the concepts of present value and future value. The present value function converts future cash flows into present value amounts. Present value and future value work much like a bank account. Start with a present amount $PV$ and place it in a bank account yielding $i$ (with compounding of interest at the end of each period). You should have $FV$ in the account after $n$ years if you avoid Jesse James and the Younger brothers and the bank does not become insolvent. Consider $PV$ the present value, $FV$ the future value, and $i$ the interest rate. This could be expressed mathematically (the compound interest equation):

$$FV = PV \times (1+i)^n$$

where:

- $FV$ = future value,
- $PV$ = present value,
- $i$ = annual interest rate (with annual compounding), and
- $n$ = number of years.

Knowing any three of these variables, you can solve for the fourth variable by using simple arithmetic (unless $i = -1$). Solve for future present value with this equation:

$$PV = \frac{FV}{(1+i)^n}$$

In this equation, $i$ is generally referred to as the “discount rate.” That is nothing more than another name for the interest rate.

Internal rate of return uses these concepts. Internal rate of return applies to a series of cash flows. Some cash flows are investments. Other cash flows are returns. The internal rate of return of a series of investments $I_1, I_2, I_3, \ldots, I_x$, that yield a series of returns $P_1, P_2, P_3, \ldots, P_y$, will be $i$ if the sum of the present values of investments $I_1, I_2, I_3, \ldots, I_x$, discounted (from the date when these cash flows occur) to a common date (usually the formation of entity) at discount rate $i$, equals the present value of the returns $P_1, P_2, P_3, \ldots, P_y$, discounted (from the date when these cash flows occur) to the same common date at discount rate $i$. You could express this as:

$$\sum_{a=1}^{a=x} \frac{I_a}{(1+i)^{\text{Periods to Cash Flow } a}} = \sum_{a=1}^{a=y} \frac{P_a}{(1+i)^{\text{Periods to Cash Flow } a}}$$

Note that $i$ must be adjusted to the number of compounding periods. Compounding periods must be consistent for all cash flows: daily, monthly, quarterly, or annual.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

This equation is not easily solved with normal mathematical tools outside of the tools of numerical analysis. We usually turn to computers or to calculators to approximate the solution of this equation. Computers and calculators approximate the solution of this equation by trial and error, making successive guesses that are closer and closer to the solution of $i$. At a certain point, the computer or calculator concludes that the answer is close enough. The computer or calculator then gives up searching. Consider how the computers and calculators try to solve this equation.

Some draftsmen say merely that the internal rate of return is whatever a particular computer program says it is. Many agreements incorporate the IRR function contained in Microsoft Excel®. That is a possible drafting solution. Describing the internal rate of return as what Microsoft Excel® says it is has several dangers. Microsoft Excel® may be discontinued. The program may be revised so that different versions of Excel® may yield different results. The search pattern in Excel® may fail to converge to a solution. Even its instructions stress that it may not find a solution. There may be a previously undiscovered bug in the software (or perhaps a discovered bug or an endless loop) that produces spurious results – or may produce no result at all. Excel® will produce only one solution when there may be multiple solutions. The internal rate of return equation may have multiple solutions for the same pattern of cash flows; merely relying on the IRR function contained in Microsoft Excel® could ignore the most appropriate solution and inappropriately result in cash flows failing to satisfy the internal rate of return test. There is another possible approach to the mathematics of this situation. Most draftsmen will set up an equation with specified cash flows and then solve for the internal rate of return resulting from these cash flows. It alternatively would be possible to specify the internal rate of return that is the goal, specify all but the last cash flow, and then to solve for the last cash flow. The agreement could specify that, if the last cash flow is equal to or greater than the final cash flow necessary to produce the specified internal rate of return, the test should be treated as satisfied.

550 Excel® has built-in compounding or fiscal year assumptions that may or may not be in accordance with the partner’s deal.

The internal rate of return equation involves what mathematicians often refer to as a high order polynomial (typically, a very high order polynomial). The equation can have many solutions if many cash flows occur, especially when a series of alternating contributions and distributions. (Graphing the function can help you identify approximate locations of real number solutions.) You want a positive real number as the solution. Most of the solutions to the internal rate of return equation are imaginary numbers. These imaginary solutions may be useful
for mathematicians. Imaginary solutions will not do you much good. Exclude imaginary solutions.

There may be spurious real number solutions that do not make much sense. Negative real number solutions do not do you much good. Exclude negative solutions.

Drafting in terms equivalent to “the internal rate of return is what Excel’s IRR function says the internal rate of return is” can be perilous. You may discover that you never reach a 7% internal rate of return. This could result from some hidden mystery in the programming of Excel.

The Excel® XIRR function, available through Excel®’s analysis add-in tool pack, often provides greater control than the Excel® IRR function. The XIRR function will compute internal rate of return for scheduled cash flows when the user specifies the dates on which the cash flows occur. The XIRR function does not require that cash flows be precisely periodic. The XIRR function permits the user to input a guess that is close to the result. Excel® uses an iterative technique for calculating XIRR. The XIRR function provides an approximation of true internal rate of return. The XIRR function uses this formula:

551 To find the XIRR function in Excel®, you need to find the Analysis Tool Pack. If the XIRR function is not installed, using it will return the #NAME? error. To load the XIRR function, instructions provide: “[o]n the Tools menu, click Add-Ins. In the Add-Ins available list, select the Analysis ToolPak box, and then click OK. If necessary, follow the instructions in the setup program.” The XIRR function can be a useful function to have installed when using Excel®. The advantage of the XIRR function is that XIRR returns the internal rate of return for a schedule of cash flows that is not necessarily precisely periodic. The XIRR can handle cash flows that occur on different days during the year. The IRR function in Excel® calculates the internal rate of return only for purely periodic cash flows (such as cash flows occurring on the last day of each month).

552 The XIRR function operates in this format: XIRR (range of cash flows, range of dates, initial guess). Microsoft Excel® uses these conventions (as explained in its on-line help manual):

*Microsoft Excel stores dates as sequential serial numbers so they can be used in calculations. By default, January 1, 1900 is serial number 1, and January 1, 2008 is serial number 39448 because it is 39,448 days after January 1, 1900. Microsoft Excel for the Macintosh uses a different date system as its default.*

*Numbers in dates are truncated to integers.*

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

\[ 0 = \sum_{i=1}^{N} \frac{P_i}{(1 + rate)^{\frac{(d_i - d_1)}{365}}} \]

where:

- \( d_i \) = the \( i^{th} \), or last, payment date.
- \( d_1 \) = the first payment date (normally the day on which first capital is contributed).
- \( P_i \) = the \( i^{th} \), or last, cash flow (whether positive or negative).
- \( rate \) = discount rate.
- \( N \) = number of periods

Computer software often uses conventions to compute internal rates of returns. Pay attention to these conventions. These conventions may make a significant difference. Computer software and calculators (for example, the IRR function in Excel\textsuperscript{®}) often compute internal rates of returns by assuming that the partnership’s taxable year has 360 days of 30-day months. This computational year may be satisfactory to your client, or it may not. Some of us inhabit a planet that has years of 365 days (except in leap year, which has 366 days). Our client may want the benefit of a year that has 365/366 days. This makes both the drafting and

---

**XIRR** expects at least one positive cash flow and one negative cash flow; otherwise, **XIRR** returns the #NUM! error value.

If any number in dates is not a valid date, **XIRR** returns the #VALUE! error value.

If any number in dates precedes the starting date, **XIRR** returns the #NUM! error value.

If values and dates contain a different number of values, **XIRR** returns the #NUM! error value.

In most cases you do not need to provide guess for the **XIRR** calculation. If omitted, guess is assumed to be 0.1 (10 percent).

**XIRR** is closely related to **XNPV**, the net present value function. The rate of return calculated by **XIRR** is the interest rate corresponding to **XNPV** = 0.

Excel uses an iterative technique for calculating **XIRR**. Using a changing rate (starting with guess), **XIRR** cycles through the calculation until the result is accurate within 0.000001 percent. If **XIRR** can’t find a result that works after 100 tries, the #NUM! error value is returned.

**XIRR** is not constructed to search for multiple solutions to the equation.
computational tasks more complicated. Pay attention to the day during the partnership’s taxable year on which cash flows occur.

The present value equation for a year that has 365 days is:

\[ PV = \frac{FV}{(1+i_{\text{daily}})^n} \]

where:

\( PV \) = present value,

\( FV \) = future value,

\( i_{\text{daily}} \) = daily interest rate determined on the basis of a 365-day year (with daily compounding), and

\( n \) = number of days.

You cannot just use 15\% for \( i \) in this equation. You might divide 15\% by 365. This gives us 0.04109589\% interest per day. You can substitute this value into the compounding equation. The trouble is that a sum X invested at 15\% annual interest, compounded annually, is not equivalent to X invested at 0.04109589\% interest per day, compounded daily. You can set up a simple equation for converting a compounded daily rate to a compounded annual rate (assuming a year of 365 days):

\[ (1 + i_{\text{annual}}) = (1 + i_{\text{daily}})^{365} \]

where:

\( i_{\text{daily}} \) = daily interest rate (with daily compounding), and

\( i_{\text{annual}} \) = daily interest rate (with daily compounding).

Solving for \( i_{\text{daily}} \), you have:

\[ i_{\text{daily}} = \sqrt[365]{(1 + i_{\text{annual}})} - 1 \]

A 15\% annual interest rate, compounded annually, equates to a 0.0382983\% daily interest rate, compounded daily, if the partnership’s taxable year has 365 days. The 15\% annual interest rate, compounded annually, equates to a 0.0381936\% daily interest rate, compounded daily, if the partnership’s taxable year has 366 days. A mathematically rigorous computation of internal rate of return (based on a 365/366-day year) must take the number of days during the computational year into account.
Computational years often do not run from January 1 through December 31. Computational years often start on an arbitrary day in one year (for example, the day immediately following the day on which money was invested) and end on the immediately preceding calendar day in the immediately following year. When do you have a 366-day year? You will have a 366-day year if your computational year includes February 29. This means that you have to analyze the length of the computational year separately for each cash flow amount.

Computations are simpler if you adopt a 360-day year of 30-day months. This computational year convention has the advantage of having all computational years with the same number of days (360), so that the daily interest accrual is equal for every year. The 15% annual interest rate, compounded annually, equates to a 3.88302988% daily date, compounded daily, based on a computational 360-day year of 30-day months. The 360-day year of 30-day months does not just happen. Specify this computational year in your partnership agreement if you wish to use it.

You will be stuck with a true calendar year of 365/366 days if your partnership agreement fails to specify another computational year (for example, a 360-day year of 30-day months). The partnership’s taxable year has 366 days every leap year. A 15% annual return, compounded annually, will equate to a 0.0382983% daily compounded interest rate if the partnership’s taxable year has 365 days. A 15% annual return, compounded annually, will equate to a 0.0381936% daily compounded interest rate if the partnership’s taxable year has 366 days. This is more computational complexity that the accountants may prefer. The accountants normally will prefer a computational 360-day year of 30-day months.

We usually undertake the computation of internal rate of return using techniques of numerical analysis. You may compute internal rate of return by using computer software or a calculator preprogrammed to search for a solution by trial and error (an organized trial and error).

Follow this procedure:

- Guess at a value for the discount rate (the same as the internal rate of return).
- Calculate the sum of the present values of the investments and the sum of the present values of the distributions.
- Compare the two sums.
- Refine your guess.
- Repeat the process.

This process continues until the difference between the two sums is acceptably small. The difference rarely will equal zero (although it should converge
to zero) on account of your inability to distribute fractional cents. Detail the computation precisely to ensure that your have specified a unique solution. Specify how close is close enough.

Some partnership agreements adopt simplifying assumptions so that cash flows are treated as occurring on the first day of a month. These conventions may simplify the partnership accountant’s task. Test simplifying assumptions for sensitivity. These conventions can result in substantial financial distortions – sometimes amounting to millions of dollars. A simple monthly convention can make a substantial economic difference. Make sure that you understand the mathematical effects of using first-day-of-the-month, first-day-of-the-quarter or first-day-of-the-year assumptions if you decide to use them. Consider whether these computational assumptions may encourage behavior that you do not wish to encourage.

Consider when a cash flow occurs. This may seem a trivial point. There often can be confusion.

Consider:

- Contributions may be made by cheque. A hold may be placed on the funds until the cheque clears. The cheque may be mailed to the offices of the partnership. The cheque may be dishonored.
- Does the cash flow occur on the day on which the cheque is dated, the day on which the cheque is mailed by the investor, the day on which the cheque is received by the partnership, the day on which the cheque is deposited, or the day on which funds are credited to the partnership?
- Does the hour of receipt of a payment make any difference? Are cheques slid under the door to the partnership’s offices after-hours considered as paid on date of delivery?
- What happens if a cheque is received by the partnership after normal banking hours?
- What happens if the partnership receives a cheque on a Saturday or Sunday or holiday?
- Is interest computed for the day of payment to the partnership or does interest begin to accrue on the immediately following day (business or banking day)?
- Is interest computed for the day of payment by the partnership or does interest begin to accrue on the immediately following date?
- These drafting issues may be reduced, but not eliminated, if funds are transmitted by wire transfer – or perhaps in cash.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING 
PARTNERSHIP AND LLC AGREEMENTS AND 
SOME BASIC ISSUES IN 
DRAFTING REAL ESTATE 
PARTNERSHIP AND LLC AGREEMENTS

- Is a wire transfer received at the last minute paid on that day or the next?
- What is the result if a wire transfer is “sent” but delayed through misadventure?
- Does interest begin on the transferred funds on the day of transfer?
- What happens if a wire transfer goes astray for a weekend?
- These issues exist equally for distributions by the partnership. When are distributions treated as made?  

Distributions under your partnership agreement are unlikely ever to produce precisely a 15% internal rate of return. Most of us live in a financial world that is inhabited by dollars and cents – or by some similar currency and discrete fractional units of that currency. Computers and calculators often can produce results to ten or more decimal places. The solution to the internal rate of return equation often involves a rate of return with endless decimals. At least, that would be the case if you computed the solution on a highly extended precision computer capable of endless decimals. The solution to the internal rate of return equation is unlikely to be precisely 15%, as cash flows do not involve fractional cents. One solution will be close to 15% but less than 15%. The next solution will be close to 15% but more than 15%. The solution rarely will be exactly 15%.

Discuss the internal rate of return provisions and the computations with both the partnership’s internal accountants and the external accountants in order to ensure that the partnership accountants understand the computations and to ensure that your partnership agreement will be followed. Even well drafted, unambiguous agreements are much less valuable if these agreements are not read carefully between the time when these agreements are signed and the time when the first dispute arises.

A common formulation requires that:

The Partnership shall make Distributions of Available Cash to Partner X under this Section x.x(a) until Partner X has received sufficient Distributions under this Section x.x(a) to give Partner X an Internal Rate of Return equal to the Specified IRR.

This provision is flawed. Partner X is unlikely ever to receive precisely a 7 percent internal rate of return. Partner X likely will jump from less than a 7 percent internal rate of return to greater than a 7 percent internal rate of return. Take this into account in drafting your partnership agreement. This provision also does

---

553 Your partnership agreement needs to address these issues if your partnership agreement is to produce unambiguous results.
not satisfactorily address the possibility that the condition will have been met and later Partner X will have contributed capital to the partnership. It is not clear whether the internal rate of return condition is retested after it once has been satisfied.

A group of cash flows may give Partner X two different internal rates of return at the same instant. This situation often will occur if the partnership returns all of the cash investment of the partners, plus a return, and then the partners are required subsequently to reinvest the distributed cash. Clarify whether the internal rate of return condition has been met if distributions give Partner X both a 5% internal rate of return and a 15% internal rate of return. Initial contributions, subsequent distributions, and then a second set of distributions can result in multiple solutions to the internal rate of return equation. This might result when there is a distribution of refinancing proceeds after several years, and then there is a subsequent capital call. (Some partnership agreements will compute modified internal rates of return and assume a low rate of return or even zero rate of return for cash flow that has been distributed to partners.) Clarify whether distributions under lower tiers of the distribution provision will be treated as helping to satisfy the internal rate of return distribution. They generally should not be considered, although many carelessly drafted internal rate of return provisions fail to appreciate this subtlety. Earlier year distributions under paragraphs (b), (c), (d), etc. generally should not be considered in determining whether the internal rate of return test in paragraph (a) has been met.

This provision is better:

(a) The Partnership shall make all Distributions of Available Cash to Partner X under this Section x.x(a). Distributions shall be made under this Section x.x(a) while the Distributions of Available Cash to Partner X under this Section x.x(a) give Partner X an Internal Rate of Return (from the formation of the Partnership) that is less than the Specified IRR. For this purpose, the computation shall consider only the lowest positive real number Internal Rate of Return to Partner X). The Accounting Conventions shall apply in making these computations.

---

554 If you use “until” rather than “while,” clarify whether the tier is retested every year, or whether the test, once met, is treated as met forever.

555 This formulation considers only distributions under the specified tier in giving the partner the internal rate of return. Some agreements count distributions subsequent to the internal-rate-of-return tier in satisfying the internal rate of return hurdle. Including distributions under later tiers in satisfying the internal-rate-of-return hurdle can create unwanted effects when the internal rate of return hurdle (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The Accounting Conventions are set forth in the text accompanying note 545.

The internal rate of return involves a mathematically complicated inquiry. Define “Internal Rate of Return” carefully and precisely. The internal rate of return equation involves the solution of a complicated high order polynomial equation. Many solutions to the internal rate of return equation are imaginary numbers. Exclude these imaginary number solutions from the definition of “internal rate of return” in your partnership agreement. You normally want to consider only positive real number solutions. You could find it unpleasant to find yourself in state court fighting over whether an imaginary number solution to the internal rate of return equation satisfies the requirements of moving from one tier to another in your partnership agreement. You could find yourself embarrassed to find yourself in court fighting over what happens when the investor has both a 5% and a 20% internal rate of return at the same instant.

Some partnership agreements fail to consider the calendar day on which contributions are made or distributions are made. These partnership agreements treat all contributions and distributions made during the partnership’s taxable year as made on the same day. This convention, in appropriate circumstances, can cause considerable economic distortion. A carefully drafted agreement normally should account for the precise calendar day during on which contributions are made or distributions are received. This requires that you use a present value formula that is adjusted for daily rather than annual compounding. This requires a clear statement of when contributions are treated as made and when distributions are treated as received.

Some partnership agreements provide that all distributions and contributions are treated as made on the first day of the month, first day of the quarter, or even first day of the partnership’s taxable year. These computational conventions invariably will create economically unfair distortions. Avoid these conventions when drafting your partnership agreement.

once is met, but there are later capital contributions, so that the internal rate of return test is tested again.

Some authorities will criticize the internal rate of return as a poor measure of economic performance. The investor is treated as reinvesting cash flow distributions at a rate of return equal to the internal rate of return. Some authorities prefer the use of modified internal rate of return, in which it is possible to specify the earning rate on distributions. The partnership agreement can use the modified internal rate of return as the index for moving from one tier to another in the cash distribution provision; however, it is more common to use internal rate of return.
Some agreements define “internal rate of return” merely in terms of the result of a spreadsheet program. This is a sloppy drafting practice that could lead to ambiguities. Drafting income allocations is particularly challenging when cash distributions tiers are defined in terms of achieving a particular internal rate of return. Do not define internal rates of return by reference to results of a spreadsheet program (for example, Lotus 1-2-3® or Excel®). Defining an internal rate of return in terms of the results of spreadsheet calculations may incorporate unwanted conventions (for example, an unwanted computational year) and could create unwanted results in the case of software failure. This search could fail to recognize that more than one positive real number solution may exist.

Run many numerical examples (or have the partnership accountants or financial modelers run many numerical examples) in order to ensure that the cash distribution provision works satisfactorily if you draft a cash distribution provision based on achieving a specified internal rate of return. Carefully define increases and decreases to the base against which the internal rate of return is computed. Preferred return provisions are sensitive to when cash is treated as contributed and when cash is treated as distributed. Specify the formula used for computing internal rate of return, the computational year, compounding frequency, and compounding dates. Clarify how each distribution is divided among partners receiving the distribution. Clarify the precise treatment of contributions made after an internal rate of return has been achieved.

Where the internal rate of return test is applied to distributions to more than one partner, consider what happens when partners have made contributions or may receive distributions on different dates.

Consider whether to relieve the accountants of some computational burden by using a computational year of 360 days and 30-day months.

This is a simple attempt to define “internal rate of return”:

---

557 The spreadsheet program could become lost in an infinite computational loop. The spreadsheet program may discontinue searching at a specified point. The spreadsheet program may contain computational conventions that contradict those in the agreement, such as compounding, computational year, etc. The spreadsheet program may fail to identify that there are multiple positive real number solutions to the internal rate of return equation for a specified set of cash flows. The spreadsheet program may arbitrarily select one of the solutions to the internal rate of return equation.

558 An elegantly drafted provision normally should eliminate imaginary number solutions and negative number solutions to the internal rate of return. Only positive real numbers are typically useful for most partnership agreements.
“Internal Rate of Return” means the applicable specified annual percentage return on Capital Contributions made by each Partner to the Partnership. The computation of internal rate of return shall take into account the date when each Capital Contribution is received by the Partnership, and the date when Distributable Cash is distributed (or treated as distributed under this Agreement from the Partnership) and received by the applicable Partner in accordance with the Accounting Conventions. Internal Rate of Return shall be compounded monthly on the first day of each calendar month. A Partner has earned an Internal Rate of Return of \( x \) percent on Capital Contributions of \( y \) dollars when the net present value of all actual cash Distributions (including actual cash Distributions of Distributable Cash and/or Capital Proceeds) from the Partnership and received by the Partner with respect to its Capital Contributions, discounted at an annualized interest rate of \( x \) percent, compounded monthly, is equal to \( y \). These conventions shall apply in determining the Internal Rate of Return:

(a) All present value calculations are to be made as of the date Capital Contributions were contributed or treated as contributed to the Partnership;

(b) All Distribution amounts shall be based on the amount of the Distribution without considering any withholding or deduction requirements;

(c) The rate of return shall be based on per annum rates, but all present values shall be calculated based on monthly compounding and on the basis of a computational year of 12 months of 30 days each;

(d) No Capital Contributions or Distributions shall be treated as having been made before the date of this Agreement; and

(e) The Internal Rate of Return must be a positive real number (imaginary number and negative real number solutions are not considered).

This is another simple attempt to define “internal rate of return”:

Section x.x. “Internal Rate of Return” of \( I\% \) means, with respect to any Member, the distribution of Distributable Cash to such Member, such that the sum of the present values of all Capital Contributions by such Member shall be equal to the sum of the present values of all distributions of Distributable Cash to such Member, determining such present value using an annual \( I\% \) discount rate. For this purpose, the present value of a cash flow on the \( i \)th calendar day after the effective date of the Company shall be determined using this formula:
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

\[ PV (\text{payment on the } i\text{th day}) = \frac{\text{Amount of Payment}_i}{(1 + I\%)^{365}} \]

where

\( PV = \) Present Value.
\( \text{Amount of Payment} = \) Amount of Cash Flow on \( i\)th day.
\( I = \) Discount Rate.
\( i = \) number of days from formation date of the Company to the date of distributions of Distribution Amount or Capital Contribution (not counting the formation date, but counting the date of distribution).

The parties intend that the Internal Rate of Return shall be determined by using the XIRR function of Microsoft Excel (contained in its Analysis Tool Pack add-in) (or a reasonably equivalent internal rate of return function if the XIRR function shall have been superceded or renamed or Microsoft Excel no longer shall be commonly commercially available). Further, the parties intend that the Internal Rate of Return shall be determined by taking into account the timing and amounts of all distributions of Distributable Cash from the Company to such Member, and by assuming that all Capital Contributions made by a Member, occur on the day on which they are actually made or received, as the case may be.

c. Tax Distribution Provision.

An especially simplistic and ill-drafted tax distribution provision provides:

Section x.x. Special Tax Distributions. The Partnership shall distribute to each Partner an amount (the “Tax Distribution”) to each Partner to permit the Partner to pay his taxes on his distributive share from the Partnership.

This provision is likely to foment disputes among the partners.

This is another tax distribution provision that is illustrative of typical problems:

Section x.x. On or before April 15 of each year the General Partner may distribute cash from operations to each Partner in an amount equal to the excess, if any, of (i) the amount of all Net Profits (less Net Losses) and other items of income and gain allocated to such Partner pursuant to Section y.y for all prior Fiscal Years multiplied by the Tax Rate, over (ii) the
cumulative distributions previously made to the Partner pursuant to Section 2.2 for such Fiscal Year and all previous Fiscal Years (a “Nortional Tax Distribution”). The “Tax Rate” for this purpose shall be the highest combined federal, state and local income tax rate applicable to individuals resident in Atlanta, Georgia, at the relevant time with respect to the character or characters (such as capital gains and ordinary income) of the taxable income so allocated (taking into account that Georgia income taxes, if any, are deducted in determining federal taxable income). The amount of any such Nortional Tax Distribution shall be determined by the General Partner. Notwithstanding any other provisions contained herein, in no event shall any Nortional Tax Distributions be made with respect to the year in which occurs the dissolution and winding up of the Partnership or with respect to any subsequent year. Nortional Tax Distributions made to each Partner shall be treated as advances of, and shall be credited against, subsequent distributions otherwise to be received by such Partner under Article X hereof.

These are some issues to consider in connection with this provision:

- There is imprecision about this computation, since potentially there are three or more computations: one at a 15% federal rate, another at a 25% federal rate, and a third at a 28% federal rate. The Tax Rate easily could mean three separate tax rates. That is not altogether clear from the (a)(i), which makes it appear that there is a single computation.

- How is this formula applied if the partnership has $100,000 of ordinary income and $100,000 of capital losses? The Net Profits and Net Losses technically will be zero.

- What happens if tax rates are changed during the year?

- What happens which the tax law changes, such as a special tax on investment income, a tax surcharge, subjecting distributive shares to FICA, etc.?

- What happens if tax rates differ between the year in which income is earned and the year in which the tax distribution payment is made?

- What happens if there is an audit adjustment changing Net Profits allocations?

- Is there a clawback if an excess tax distribution to a partner (above amounts otherwise distributable to the partner) exists at termination of the Partnership?
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Should this tax distribution be based on Net Profits or on net taxable income allocated to the Partner? If this is based on Net Profits, then much of the potential distribution could disappear on account of past book-ups or future book-ups. A tax distribution based on Net Profits under this provision would not provide for a tax distribution based on income that is eliminated by book-ups.

- How are distributions under this provision coordinated with the various returns and tiers of distributions when the normal distributions are defined in terms of tiers of specified returns? The tax distribution provision needs to be coordinated carefully with the normal distribution provision.

- Treatment of tax distributions as advances should take care of this issue, but some additional clarifying language might be helpful wherever there is a return or distribution that could be affected by a tax distribution under Section 6.11. Note also that, as Net Profits is defined, a book up would produce Net Profits. Presumably a book up should not result in a tax distribution.
A light-weight and simplistic tax distribution provision provides:

Section x.x. Special Tax Distributions. The Partnership shall distribute to each Partner an amount (the “Tax Distribution”) in immediately available funds equal to the excess (if any) of –

(a) The Partner’s Notional Tax Liability for the immediately preceding Taxable Year, over

(b) The amounts previously distributed to the Partner in respect of the Taxable Year under this Section x.x in the preceding Taxable Year.

The Partnership shall make this Tax Distribution by no later than March 31 of each Taxable Year. These distributions may be made in installments (as determined by the General Partner) in the preceding Taxable Year in order to permit the Partners to make estimated tax payments. The Partnership shall make this distribution in United States dollars.

A “Partner’s Notional Tax Liability” for a Taxable Year means the product of –

(i) The taxable income of the Partnership allocated to the Partner for the Taxable Year (exclusive of income from guaranteed payments); multiplied by

(ii) 43%.

Notwithstanding the foregoing, no Tax Distribution shall be made after the occurrence of a Partnership Liquidation Event.

This is another typical lightweight tax distribution provision:

Section x.x. Tax Distribution. Each Fiscal Year, the General Partner (to the extent Distributable Cash is available) will cause the Partnership to make distributions to the Partners of Distributable Cash in an amount (as to each Partner) equal to the product of --
(a) The net “book” income allocated to the Partner for the Fiscal Year (exclusive of income from guaranteed payments); and

(b) The highest effective combined Federal, New York state and New York City local income tax rate applicable during the Partnership’s Fiscal Year to a natural person resident in New York City, New York, taxable at the highest combined marginal tax rates. The highest combined marginal tax rate will include the Federal income tax deduction for New York state and local income taxes (to the extent that New York state and local income taxes are deductible in computing Federal income tax). 559

Each Tax Distribution will be treated as an advance against and will be recoupable from distributions of Distributable Cash or proceeds of liquidation that otherwise would be made to the Partners under this Agreement. No Tax Distributions will be made after an Event of Liquidation of the Partnership. A Partner may have received (at the time of liquidation of the Partnership) cumulative Tax Distributions in excess of the cumulative amount that has been recouped from Distributable Cash or proceeds of liquidation otherwise distributable to the Partner. That excess (if any) constitutes a demand loan to the Partner. This demand loan will be repayable in accordance with the provisions of this Agreement regarding demand loans by the Partnership to Partners.

This is another lightweight tax distribution provision:

559 There is increasing question whether tax distribution provisions should take into account the federal income tax deduction for state income taxes. There also is increasing question whether tax distribution provisions should be based on maximum federal and state tax rates. Alternative minimum tax may eliminate the tax benefit of the state tax deduction. Draftsmen should consider how the alternative minimum tax may affect the tax liabilities of the partners. Also, consider the possibility that a partner may be a pass-through entity that is not subject to tax or that is subject to tax at reduced rates.
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

Section x.x. **Tax Distribution.** Each Fiscal Year, the General Partner will cause the Partnership to make distributions to the Partners of Distributable Cash in an amount (as to each Partner) equal to the Tax Distribution Amount. This distribution will be made no later than April 15 of each Fiscal Year. No Tax Distributions will be made after an Event of Liquidation of the Partnership. Any distribution will be made under this Section x.x only to the extent that Distributable Cash is available for this purpose.

For this purpose,

(a) The Tax Distribution Amount means an amount (computed with respect to each Partner) equal to the sum of federal, state, and local income taxes, net of the federal tax benefit for state and local taxes (if any), that hypothetically would be payable by the Partner with respect to its allocation of taxable items of income, gain, depreciation, depletion, and loss for the Fiscal Year from the Partnership. Income from guaranteed payments shall be excluded from this computation. The Tax Distribution will be calculated with respect to the tax items allocated to the Partner by the Partnership for the immediately prior Fiscal Year. This computation will take into account taxes on self-employment income, income tax surcharges, Medicare/Medicade, special taxes on net investment income, and similar matters.

(b) If (at the time of liquidation of the Partnership) a Partner has received cumulative Tax Distributions in excess of the cumulative amount that has been recouped from first Distributable Cash or proceeds of liquidation otherwise distributable to the Partner, that excess will constitute a demand loan from the Partnership to the Partner. This demand loan will be repayable by the Partner in accordance with the provisions of this Agreement concerning demand loans by the Partnership to Partners.

(c) Any Tax Distribution made under this Section x.x is an advance against amounts of Distributable Cash otherwise distributable to a Partner and will be recouped from the amounts otherwise distributable to the Partner.\(^560\)

(d) All income that is taxable as ordinary income is treated as taxable at the tax rate for the highest bracket for taxable income applicable to an individual taxpayer for federal, state, and local purposes, assuming for purposes of computation that the Partner is an individual resident

\(^{560}\) Consider how this clause should be modified (if at all) in light of the alternative minimum tax.
of Apache Flats, Arizona, regardless of the nature of the Partner or the actual residence of the Partner.  

(e) All short-term capital gain is treated as taxable as ordinary income.

(f) All long-term capital gain and all gain from the sale of a Section 1231 asset are treated as taxable at the tax rate applicable the highest bracket for long-term capital gains for federal, state, and local purposes.

(g) All long-term unrecaptured Section 1250 gain is treated as taxable at the highest taxable rate applicable to long-term unrecaptured Section 1250 gain for federal, state, and local purposes, considering Code Section 1(h)(D).

(h) All nontaxable income is treated as taxable at a zero percent (0%) rate.

(i) All carryover items of the Partner from prior or subsequent Fiscal Years are disregarded and all tax items of the Partner not attributable to the Partnership are disregarded. This includes (without prejudice to generality) operating loss, passive loss, and credit carryovers.

(j) The minimum tax and alternative minimum tax are disregarded.

(k) Increased items of income, gain, depreciation, depletion, or loss attributable to a “book”-tax disparity and specially allocated to the Partner under Section 704(c)(1)(A) are disregarded. The immediately previous sentence is qualified by the limitation that increased items attributable to a revaluation of Partnership assets will not be disregarded.

(l) Full consideration is given to adjustments under Section 734 and Section 743 resulting from any election made under Section 754. (For example, a positive adjustment to the basis of a Partner’s share of Partnership property under Section 743 shall reduce the tax distribution to such partner in accordance with the manner in which it would reduce the hypothetical tax liability of the partner computed under the principles of this Section x.x)

(m) Full consideration is given to the timing of the inclusion of the tax items if the tax rates change during the Fiscal Year.

561 Make sure to consider special tax rates, such as California’s Mental Health Services Tax (“millionaire’s tax”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(n) Surcharges on income tax (as applicable) are considered in the computation of the Tax Distribution Amount.

(o) Federal taxes result in Tax Distributions only to the extent that the tax items are taxable for federal purposes. State taxes result in Tax Distributions only to the extent that the tax items are taxable for Arizona tax purposes. Local taxes result in Tax Distributions only to the extent that the tax items are taxable for purposes of any local Apache Flats tax purposes.

(p) No special Tax Distributions are to be made on account of Partner’s estimated tax liabilities.

(q) The tax effects of tax credits from the Partnership will be considered as offsets to tax liability in computing the Tax Distribution Amounts.

(r) The Tax Distribution Amount will be readjusted appropriately on account of readjustment of the tax items of the Partnership on audit by appropriate governmental authorities or on amendment of the Partnership’s tax returns.

This is another attempt to address estimated taxes:

(a) Tax Distributions will be made to each Member for each Fiscal Quarter for which an estimated tax payment is due. These Tax Distributions will be paid (in an amount computed on the basis of the estimated net taxable income of the Company) not later than 15 days prior to the due date of individual estimated tax payments. Tax Distributions will be based on good faith estimates by the Company’s accountants of the combined state and federal tax liability of the Member attributable to the Member’s distributive share from the Company (exclusive of income from guaranteed payments). These estimates will be based on assuming that each Member is an individual resident of ****. Tax Distributions for any Fiscal Year in excess of the estimated amount paid pursuant to the preceding sentence will be paid in an amount not later than March 31 of the Fiscal Year in which the tax is due. This amount will be estimated in good faith by the Company’s accountants.

Partnership agreements frequently provide special priority tax distributions to permit partners to pay taxes on their distributive shares of partnership income. Careful tax distribution provisions require considerable thought – yet

562 Tax distributions are not discussed at all in Treasury Regulations concerning partnership allocations.
even these careful provisions are imperfect in the sense in which they provide rough estimates of tax liability. Tax distribution provisions should be prepared in consultation with the partnership’s accountants. Tax distribution provisions are useful within limits and often break down when stressed. A “perfect” tax distribution provision does not exist. Tax distribution provisions invariably consider some issues and ignore others. The theories underlying tax distribution provisions differ. Some provisions are designed merely to ensure minimum distribution levels. Other provisions are designed so that the entity in effect bears tax on its income. Tax distribution provisions invariably are imperfect. Do not fret if you fail to craft the “perfect” tax distribution provision. Draft a functional provision that meets the needs of your partnership and does not operate badly in practice. There invariably will be some difference between the hypothetical tax that your tax distribution provision computes and the partner’s actual tax liability. Draft your tax distribution provision so that it does not produce a grand economic bonanza for one of the partners.

Perhaps the first point in drafting a tax distribution is deciding how mandatory the tax distributions are. Is the tax distribution dependent on the availability of cash flow to distribute, or much the partnership sell assets or borrow to meet the tax distribution requirement? In appropriate circumstances, a tax distribution provision could force the partnership to liquidate assets or to borrow on disadvantageous terms. A partner facing large tax liabilities resulting from partnership operations nevertheless might insist that the tax distribution provision require mandatory tax distributions, regardless of the availability of cash from normal partnership operations. In drafting these distribution provisions, consider the limitations under partnership debt agreements and other partnership agreements, in addition to limitations under partnership law, bankruptcy law, and state laws concerning fraudulent conveyances.

A tax distribution provision might provide offsets against future tax distributions on account of prior losses allocated to a partner. The tax distribution provision might require computation of hypothetical tax savings for these earlier years – or it can be based on merely offsetting earlier Net Losses allocated to a partner against Net Profits allocated to the partner before the tax distribution provision applies.\(^563\) Consider basing the computation of the offset on the various

\(^{563}\) Consider the effects of income allocated under I.R.C. § 704(c)(1)(A) and the income allocated to a partner on account of asset revaluations. You may decide that income allocated under I.R.C. § 704(c)(1)(A) should not result in a tax distribution. The partner entered the partnership with this personal built-in tax problem. A better case can be made that the partnership should indemnify tax on income resulting from revaluation surplus.
rates in effect for different categories of income in those earlier years. Consider tax-effecting prior losses. Impute interest on the hypothetical prior tax benefit from the date of the hypothetical tax savings (for example, due date of the member’s returns). Use that amount as an offset against future tax distributions. Consider requiring partners to make capital contributions to the partnership equal to the annual hypothetical tax benefit from tax losses in early years. These contributions would be consistent with many theories of tax distribution provisions. A partner who receives tax distributions on his distributive share of income perhaps should pay for partnership-related tax benefits. Coordinate both the regular distribution provisions and liquidation provisions with your tax distribution provision.

Some provisions have an offset for notional state tax. Other provisions consider that the notional state tax deduction may be lost on account of the alternative minimum tax – or that state tax deduction might be repealed in the future. Some tax distribution provisions make corrections on account of audit adjustments.

Some tax distribution provisions are based on highest combined effective federal and state tax rates. Some tax distribution provisions are based on the combined federal and state tax rates that apply to the highest brackets of income. History has shown that these rates are not necessarily the same. Some provisions consider potential income tax surcharges that occasionally have been imposed. Many do not.

Tax distributions may be made either as advances against future regular or liquidating distributions or as absolute distributions. Tax distributions often are recouped from future distribution amounts otherwise distributable to the recipient partners. Tax distribution provisions sometimes have clawbacks for excess distributions (provisions for returning excess tax distributions or distributions not recouped out of other regular or liquidating distributions). Many tax distribution provisions do not have clawbacks.

Tax distribution provisions are not featured in all partnership agreements, nor should they be. Two foundational theories underlie tax distribution provisions. One theory is that the tax distribution provision substitutes for the entity bearing its own taxes. These taxes are passed through to the partners with their distributive shares of partnership income. Another theory is that partnerships frequently produce taxable income in excess of tax distributions and some partners (particularly service partners) simply could not afford to be partners in the absence of tax distribution provisions. Counter-arguments can be made to both of these theories. The strongest may be: the tax distribution provision just is not part of the deal; every partner should pay his own taxes. A partner who cannot afford to pay his taxes on his distributive share of partnership income, should not be a partner.
Do not automatically include a tax distribution provision in your partnership agreement. Tax distribution provisions are difficult to draft and often difficult to interpret. Poorly drafted tax distribution provisions – perhaps even well-drafted tax distribution provisions – can disrupt partnership economics.

Tax distribution provisions often contain clawbacks of excess distributions. Those clawbacks are difficult to enforce against partners – cash is easier to give than to get back.

Test whether your tax distribution provision will affect the economics of the deal. The desirable result usually is that your tax distribution provision normally should not affect the economics of the deal. A tax distribution provision may have dramatically changed the economics of the deal in Interactivecorp. v. Vivendi Universal, S.A., C.A. No. 20260 (Delaware Chancery Court (July 6, 2004)). The Delaware Chancery Court in this case held that hundreds of millions of dollars in tax payments to a party under a tax distribution provision did not reduce other cash distributions to the partner under the partnership agreement between Vivendi Universal and USA Interactive. The tax distribution provision in that case provided for a payment equal to the product of “the amount of taxable income allocated to the Partner for such taxable year … and … the aggregate marginal statutory’ tax rate.” This language is not a model on which to base your tax distribution provision. An important argument in the Interactivecorp. v. Vivendi Universal case was that the tax distribution was absolute (rather than a draw against or recoupable from other distributions) resulted in the tax distribution being an indemnity from taxes on the partner’s distributive share of partnership income and that the parties never intended an indemnity. This argument persuaded the Delaware Chancery Court. A more conventional model of tax distribution provision would have recouped future regular and liquidating cash distributions from the earlier tax distribution.

Consider stating expressly that the tax distribution is an advance to enable a partner to pay his tax resulting from partnership operations and is not intended to indemnify partners against their taxes on partnership income. This advance should be recovered through offset against future operating distributions and liquidating distributions. A telling comment is made in the Interactivecorp. v. Vivendi Universal case. The losing party referred to the tax distribution provisions in its brief as “a standard boilerplate tax distribution provision, [that] was designed to ensure that the holders of common interests in VUE would have adequate liquidity to pay their respective share of the taxes allocated under the Partnership

564 See Rita Farrell, “Victory for InterActiveCorp in Tax Dispute With Vivendi,” NEW YORK TIMES (July 2, 2004).

565 Interactivecorp. v. Vivendi Universal at 22.
Agreement as they fell due.” In the words of the Delaware Chancery Court: “the pleadings show a contract that is unambiguous on its face and the product of long negotiation between sophisticated parties supported by some of the world’s most well-regarded investment banks and law firms. USA is not seeking a ‘double dip’ as Vivendi alleges, but merely what it contracted for.” This litigation ultimately was resolved by the parties by confidential settlement and mutual releases (June 8, 2005). The final settlement is not general public knowledge.

Avoid tax distribution provisions that provide that your partnership merely will make a distribution to a partner in an amount equal to his tax liability from partnership income without any provision for offset or recoupment. These provisions are ambiguous and will lead to contention. These provisions may force a partner to disclose his tax returns to the other partners.

Tax distribution provisions often are based on the same notional tax rate (or a set of notional tax rates) for all partners. The same notional tax rate should apply regardless of whether some partners are individuals and others are corporations. The same notional tax rate should apply regardless of whether some partners live in different states from others or move from one state to another. Basing tax distribution payments on common notional rates creates consistency of tax distributions to all partners, regardless of their individual circumstances. Tax distributions sometimes deliberately consider some of the individual tax circumstances of each partner. A tax-exempt partner might not receive tax distribution payments under a scheme that takes into account individual tax circumstances. Not giving a tax-exempt partner tax distributions may make perfect sense to an individual partner. The tax-exempt partner may not see the wisdom of all other partners receiving tax distributions but the tax-exempt partners not receiving tax distributions.

Treat tax distribution payments as a draw or advance against future distributions to the partner receiving the tax distribution payments. A partner otherwise may receive both the tax distribution and the regular distribution. This will distort partnership economics. Future distributions should recoup the tax distribution payments. A clawback should recover excess distributions if the normal future distributions do not materialize. Failure to provide for offset and recoupment may result in a partner receiving both a tax distribution payment plus the partner’s normal cash distribution. Clawbacks can be difficult to negotiate and even more difficult to enforce. The money from the earlier tax distribution often is gone when time for a clawback comes. It is easier to draft a clawback provision than to collect a clawback payment from a partner.

Consider whether tax distributions should be made on account of the built-in gain in contributed property. This often is the result with a tax distribution provision that is based on taxable income allocated to partners, such as this: “‘Tax Distribution Amount’ means, for a Member, with respect to a Fiscal Year, the
product of (a) the net taxable income, if any, allocated to that Member by the Company for that Fiscal Year and (b) the sum of (i) the highest marginal rate of federal income tax applicable to individuals for that Fiscal Year, plus (ii) the highest marginal rate of state income tax applicable to individuals residing in California for that Fiscal Year, in each case determined by taking into account the different tax rates that may be applicable to different types of income and by assuming that all of the income gains, losses, deductions, and credits relative to the Company are allocable solely to California and the fact that state income tax is deductible for federal income tax purposes, but determined without regard to phase-outs, alternative taxes and the like and without regard to any other tax attribute of the individual.” Perhaps the base against which the tax distribution should be computed might be Net Profits rather than taxable income allocated to the partners. Contributing partners may prefer that tax distributions be based on allocations of taxable income and gain, not just allocations of Net Profits. A tax distribution based on taxable income and gain will include a distribution on a count of income from contributed property with differences between fair market value and adjusted tax basis (Section 704(c)(1)(A)). A noncontributing partner might argue that income associated with built-in gain should not result in a tax distribution payment to the contributor. The built-in gain should be treated as the contributing partner’s personal tax problem with which the partnership should not concern itself.

Partners who have received allocations of revaluation surplus might argue that they should receive tax distributions based on income or gain associated with revaluation surplus. This argument makes sense. The tax distribution provision might appropriately base tax distributions on both allocations of Net Profits and allocations of income or gain associated with revaluation surplus.

Better drafted provisions often are based on notional tax liability. These well-drafted tax distribution provisions can be complicated. Consider:

- Notional combined federal and state tax rates. (Make sure to specify which state you are considering.)
- Whether tax distribution payments are based on individual tax circumstances of each partner.

---

566 It also is possible to base provisions on actual tax liabilities. These provisions typically involve with and without computations. They should set forth a mechanism for making the computations, such as designating a neutral accountant to make the computations. These provisions typically provide for reimbursement of the excess of (i) the partner’s tax liability with partnership items, over (ii) the partner’s tax liability hypothetically computed without partnership items.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Whether you want to base tax distributions on local income taxes.
- Tax rate changes (including rate changes midway through the partnership’s taxable year, so that income realized early in the partnership’s taxable year may be taxed at one rate and income realized late in the partnership’s taxable year may be taxed at another rate).
- Potential income tax surcharges.
- Other potential future changes in tax laws (for example, repeal of federal deduction for state taxes or expansion of alternative minimum tax) or in the tax system and perhaps even fundamental tax reform (for example, replacement of the income tax with a consumption tax).
- Different tax rates for income of different character (ordinary income, Section 1250 recapture [recapture with respect to real property], capital gains, and corporate dividends).
- How to deal with the prospect of alternative minimum tax.
- Dealing with the possibility that a transaction may be nontaxable for federal tax purposes but taxable for state tax purposes.
- Notional federal deduction for state tax (and the possibility that this deduction may be repealed in the future or effectively unavailable on account of alternative minimum tax).
- Dealing with the possibility that a partner’s distributive share will be subject to FICA.
- Dealing with the possibility that a partner’s distributive share will be subject to Medicare tax or tax on net investment income.
- Dealing with the possibility of special tax rates on high income taxpayers.
- Quarterly cash distributions for estimated tax.
- Annual claw back of excess tax distributions if interim tax distributions exceed notional tax liability.
- Offset against tax distributions if income in early years is followed by losses in later years (and the possible tax efficiency or ineffi-

Draftsmen should consider effects of the alternative minimum tax on these provisions.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

ciency of these earlier losses if tax rates have changed in the interim).\(^{568}\)

- Possible recoupment of tax distributions if early year income allocations are reversed by later year loss allocations.
- Effects of tax credits allocated to partners by the partnership.
- How tax distributions are recouped from other future distributions of cash flow or proceeds from sale or liquidation.
- Exclusion (or inclusion) of income specially allocated to a partner under tax rules concerning contributed property – tax distribution based on net “book” income.\(^{569}\) This should apply to true allocations under the partnership rule governing allocations of tax items attributable to contributed property (Section 704(c)(1)(A)), but perhaps not to allocations treated as made under these rules on account of asset revaluations.\(^{570}\)

---

\(^{568}\) Clawbacks can be structured in various ways. If a partner received losses in early years followed by income in subsequent years, the partner might not receive any tax distribution payment until income allocations offset earlier loss allocations. A more sophisticated clawback provision might tax-effect the earlier losses and provide for a current tax distribution only where notional tax distribution payments on income exceed notional prior tax benefits from losses. Alternatively, a more sophisticated provision might tax-effect and present value earlier loss allocations and provide for a current tax distribution only to the extent that the present value of notional tax distribution payments on income exceed the present value of the notional tax benefit of earlier loss allocations.

\(^{569}\) This provision, I.R.C. § 704(c)(1)(A), typically allocates gain on sale disproportionately to the contributing partner on account of the initial disparity between fair market value and adjusted tax basis. The initial “book”-tax disparity is a problem that the contributing partner had going into the partnership; this is not a problem created by partnership operations. Theory of denying the contributing partner a tax distribution on account of income associated with this gain (“Section 704(c) gain”) is that the tax problem was the contributor’s tax problem going into the deal and that the partnership should not be concerned by it. The contributing partner could ask the partnership to bear all of the tax on account of this Section 704(c) gain. The contributing partner might reason that this tax should be the partnership’s problem. The partnership did not have to sell the contributed asset.

\(^{570}\) The better practice is not to base the tax indemnification blindly on Net Profits. A revaluation of partnership assets potentially can create Net Profits. Re-

(footnote continued on the next page)
Exclusion of nontaxable income.

Whether basis adjustments under Section 743 are considered in the computation.

Whether tax distributions are absolute distributions or whether these tax distributions must be returned if the tax distributions are not fully recouped from other distributions to the partner (and, if recoupable, from what distributions are the tax distributions recoupable).

Whether the partnership should continue to make tax distribution payments once the partnership has gone into liquidation?

What procedure should be followed if an adjustment is made on audit or in litigation. Who will control defense? This can be a particularly touchy issue if the tax liability is resolved in an audit of the partner personally and not a TEFRA audit of the partnership. Defense provisions often are extensive and highly detailed. Defense provisions can include who controls defense, who selects counsel, extensions of statutes of limitations, participation, notices, ability to settle or compromise, choice of forum, who bears expenses, etc.

Whether the distribution extends to tax penalties and interest if there is an adjustment on audit or in tax litigation.

valuation surplus, however, should not result in an immediate tax indemnification payment. Revaluations can reduce future Net Profits allocations to a partner but result in deemed allocations in accordance with the principles of I.R.C. § 704(c)(1)(A). The taxable income recognized by the partner on account of the revaluation and the operation of I.R.C. § 704(c)(1)(A) principles should result in a tax indemnification payment. It could be argued that tax indemnification payments normally should not be made on account of true I.R.C. § 704(c)(1)(A) income or gain allocations to a partner, including remedial allocations and curative allocations.

Tax distribution provisions often apply a notional tax rate to the Net Profits allocated to a partner. This will have the effect of excluding Section 704(c) income allocated to the partner. A revaluation of partnership assets can eliminate the gain in an asset. A tax distribution provision based on Net Profits can fail to provide a tax distribution for gain eliminated from “book” income by the revaluation. In any event, the tax distribution provision should be drafted so that the partnership does not reimburse notional tax based on a distributive share of nontaxable income of the partnership.
No perfect tax distribution provision works for all deals. Rethink the tax distribution for each deal. Rethink for each deal whether your partnership agreement should contain a tax distribution provision.

d. Partnership Withholding.

Section x.x. Withholding.

(a) The Partnership shall withhold from Distributions (or on account of allocations to a Partner) those amounts required to be withheld under the Code, the laws of any state or any other provision of law.

(b) Any amounts so withheld shall be treated as having been distributed to that Partner under this Agreement.

(c) The Partnership shall remit any sums withheld under this provision to (and file the required forms with) the appropriate governmental agency.

(d) A Partner shall be limited to an action against the appropriate governmental agency for refund if there is any claimed overwithholding.

(e) Each Partner waives any claim or right of action against the Partnership or anyone acting on behalf of the Partnership on account of this withholding.

(f) If the amounts required to be withheld exceed the amounts that otherwise would have been distributed to a Partner, the Partner shall contribute any deficiency to the Partnership (within ten (10) Business Days after notice from the Partnership) (regardless of whether the Partner disputes the withheld amounts).

(g) The failure of the Partner to contribute the deficiency within that time, shall constitute an Event of Default by that Partner.

(h) Any non-contributed amounts shall be considered a demand loan from the Partnership to that Partner. This demand loan shall bear interest at a rate equal to the lesser of ten percent (10%) or the highest rate permitted by law. Interest shall be computed on the basis of a computational year of 360 days comprised of 30-day months. Interest shall be compounded annually on the anniversary of the loan. This demand loan shall be repaid in full within five (5) Business Days after demand. For this purpose, any Partner may unilaterally make the demand for and on behalf of the Partnership.

Federal tax law often requires tax withholding on distributions to foreign partners. State tax law may require tax withholding on distributions to nonresidents or on nonresidents’ allocations of partnership income. Authorize withhold-
ing on partner distributions. Treat required withholding that exceeds distributions to the partner, as partner demand loans. Consider providing that the partner’s only action on account of withholding is against the United States or state taxing authorities (rather than the partnership).\textsuperscript{571}

e. State Law Distribution Limitations.

Section x.x. Limitations on Distributions.

(a) Notwithstanding anything in this Agreement to the contrary, the Company shall not make a Distribution to a Member to the extent that (at the time of the Distribution, after giving effect to the Distribution)

(i) All liabilities of the Company (other than liabilities to Members on account of their Company Interests and liabilities for which the recourse of creditors is limited to specified property of the Company) exceed –

(ii) The fair value of the assets of the Company. For this purpose, the fair value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the Company only to the extent that the fair value of that property exceeds that liability.

(b) For purposes of this Section x.x, “Distribution” does not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.

(c) A Member who receives a Distribution in violation of this Section x.x and who knew at the time of the Distribution that the Distribution violated this Section x.x, shall be liable to the Company for the amount of the Distribution.

(d) A Member who receives a Distribution in violation of this Section x.x and who did not know at the time of the Distribution that the Distribution violated Section x.x, shall not be liable for the amount of the Distribution.

Or

Section x.x. Limitations on Distributions. Notwithstanding anything in this Agreement to the contrary, the Company shall not make a Distribution

\textsuperscript{571} Some commentators assert that partnership withholding under I.R.C. § 1445 should not create an enforceable loan from the partnership to the partner.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

to a Member to the extent that this Distribution is prohibited by Delaware Limited Liability Company Act Section 18-607 or by other applicable federal or state law.

Cash distribution provisions normally reflect limitations imposed by state law or federal bankruptcy law.\textsuperscript{572}

f. Distributions of Property.

Section x.x. In-Kind Distributions. The General Partner shall not distribute any property to Partners other than money.

\begin{footnotesize}
\begin{itemize}
\item Delaware limited liability company law says:
\begin{quote}
A limited liability company shall not make a distribution to a member to the extent that at the time of the distribution, after giving effect to the distribution, all liabilities of the limited liability company, other than liabilities to members on account of their limited liability company interests and liabilities for which the recourse of creditors is limited to specified property of the limited liability company, exceed the fair value of the assets of the limited liability company, except that the fair value of property that is subject to a liability for which the recourse of creditors is limited shall be included in the assets of the limited liability company only to the extent that the fair value of that property exceeds that liability. For purposes of this subsection (a), ‘distribution’ shall not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.
\end{quote}
\end{itemize}
\end{footnotesize}

Delaware Limited Liability Company Act § 18-607(a).

Further, \begin{footnotesize}
\begin{itemize}
\item member who receives a distribution in violation of subsection (a) of this section, and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to a limited liability company for the amount of the distribution. A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution. Subject to subsection (c) of this section, this subsection shall not affect any obligation or liability of a member under an agreement or other applicable law for the amount of a distribution.
\end{itemize}
\end{footnotesize}

Delaware Limited Liability Company Act § 18-607(b). See, also, Uniform Fraudulent Transfer Act §§ 4, 5; Bankruptcy Code §§ 547, 548.
Partnership agreements often contain limitations on in-kind-distributions of property to partners.

**g. Returns Preferred to Capital Distributions to One Partner.**

Many agreements that do not liquidate in accordance with partners’ capital accounts provide for preference of profit payments to one partner to the return of capital to another. You often do not know whether the profits distribution is a distribution of economic profits or whether the second partner’s unrecovered capital contribution bears the economic burden of the distribution until the partnership liquidates. Agreements that provide for internal-rate-of-return tiers are but one example of a much larger class of partnership agreement. These partnership agreements may result in capital shifts, in guaranteed payments, in deemed special allocations of gross income items, or in something else. Partnership case law, statutory law and administrative law have not established a clear analytical structure for considering capital shifts.

A partnership agreement provides that Clytaemnestra will be entitled to a 10% return, compounded annually and accruing if not paid, on her unrecovered capital contribution. Both Clytaemnestra and Hortense make substantial capital contributions of $1,000,000 each. Cash from operations is distributed:

1. First, to Clytaemnestra until Clytaemnestra has recovered her accrued 10% return (after crediting any return paid to Clytaemnestra previously from partnership operations).
2. Second, 50% to Clytaemnestra and 50% to Hortense.

On liquidation, proceeds will be distributed:

1. First, to Clytaemnestra to return her unrecovered capital contribution.
2. Second, to Clytaemnestra until Clytaemnestra has recovered her 10% return (after crediting any return paid to Clytaemnestra from partnership operations).
3. Third, 50% to Clytaemnestra and 50% to Hortense.

The partnership agreement provides that partners will not have liability for deficit capital accounts.

The partnership has these simplified results in years 1 through 5 (with a sale of its property in year 5):

---

573 The allocations in these partnership agreements will not have substantial economic effect.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Income</th>
<th>Gross Loss</th>
<th>Annual Net Income</th>
<th>Net Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$0</td>
<td>$30,000</td>
<td>($30,000)</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>$10,000</td>
<td>$50,000</td>
<td>($40,000)</td>
<td>$0</td>
</tr>
<tr>
<td>3</td>
<td>$20,000</td>
<td>$52,000</td>
<td>($32,000)</td>
<td>$40,000</td>
</tr>
<tr>
<td>4</td>
<td>$35,000</td>
<td>$54,080</td>
<td>($19,080)</td>
<td>$50,000</td>
</tr>
<tr>
<td>5</td>
<td>$157,010</td>
<td>$56,243</td>
<td>$100,767</td>
<td>$90,000</td>
</tr>
<tr>
<td>6</td>
<td>$750,000</td>
<td>$58,493</td>
<td>$691,507</td>
<td>$2,491,194</td>
</tr>
<tr>
<td>Total</td>
<td>$972,010</td>
<td>$300,816</td>
<td>$671,194</td>
<td>$2,671,194</td>
</tr>
</tbody>
</table>

This chart shows the accrual and payment of the preferred return to Clytaemnestra:

<table>
<thead>
<tr>
<th>Year</th>
<th>Unreturned Capital Clytaemnestra + Accumulated Unpaid Preferred Return</th>
<th>Preferred Return Accrual to Clytaemnestra</th>
<th>Preferred Cash Distribution to Clytaemnestra</th>
<th>Unpaid Preferred Return Accrual to Clytaemnestra for this Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$0</td>
<td>$100,000</td>
</tr>
<tr>
<td>2</td>
<td>$1,100,000</td>
<td>$110,000</td>
<td>$0</td>
<td>$110,000</td>
</tr>
<tr>
<td>3</td>
<td>$1,210,000</td>
<td>$121,000</td>
<td>$40,000</td>
<td>$81,000</td>
</tr>
<tr>
<td>4</td>
<td>$1,291,000</td>
<td>$129,100</td>
<td>$50,000</td>
<td>$79,100</td>
</tr>
<tr>
<td>5</td>
<td>$1,370,100</td>
<td>$137,010</td>
<td>$90,000</td>
<td>$47,010</td>
</tr>
<tr>
<td>6</td>
<td>$1,417,110</td>
<td>$141,711</td>
<td>$141,711</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$738,821</td>
<td>$321,711</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Capital accounts should be consistent with how the partnership would distribute the proceeds of liquidation. This suggests the possibility of a series of capital shifts from Hortense to Clytaemnestra so that the partnership could liquidate in accordance with capital accounts when the partnership distributes in accordance with its liquidation scheme: 1. First, to Clytaemnestra to return her unrecovered capital contribution; 2. Second, to Clytaemnestra until Clytaemnestra has recovered her 10% return (after crediting any return paid to Clytaemnestra from partnership operations); 3. Third, 50% to Clytaemnestra and 50% to Hortense.

A preferred return of $100,000 accrues to Clytaemnestra in year 1. No cash flow is available to pay this preferred return. No items of gross income are available to support the preferred return to Clytaemnestra. The partnership might liquidate at the end of year 1 at “book” value. The partnership first would distribute the proceeds of liquidation to Clytaemnestra to return her $1,000,000 capital
contribution and then her $100,000 preferred return. As Hortense’s capital is subordinated to the payment of Clytaemnestra’s preferred return, this suggests the possibility of a $100,000 capital shift from Hortense to Clytaemnestra in year 1. This capital shift does not necessarily occur in year 1, but a capital shift is a possibility. The capital shift may be necessary for capital accounts properly to reflect partnership economics, presuming that the “book” values accurately reflect partnership economics.

Another possibility is that the accrued preferred return possibly could take the form of a $100,000 guaranteed payment to Clytaemnestra, with Clytaemnestra constructively contributing the proceeds of the guaranteed payment to the partnership and the partnership specially allocating the $100,000 deduction to Hortense. This is consistent with an example in the regulations concerning guaranteed payments.574 Perhaps the guaranteed payment is deferred until the guaranteed payment is paid to Clytaemnestra.

In year 2, the partnership accrues a $110,000 preferred return to Clytaemnestra. The partnership distributes no cash to Clytaemnestra in satisfaction of the preferred return. The $110,000 preferred return accumulates. There is $10,000 in gross income available to allocate to Clytaemnestra. The first $10,000 in gross income should be allocated to Clytaemnestra to support the accrual of the preferred return. This leads an income deficiency of $100,000 in year 2. One possibility is that there is a $100,000 taxable capital shift from Hortense to Clytaemnestra. Hortense’s return of capital is subordinated to the payment of Clytaemnestra’s preferred return. Another possibility is that Clytaemnestra should be treated as receiving a $100,000 guaranteed payment, with the deduction specially allocated to Hortense. Clytaemnestra would be treated as recontributing the proceeds of the guaranteed payment to the partnership. Perhaps the guaranteed payment is deferred until the guaranteed payment is paid to Clytaemnestra. Then it might be characterized as an allocation of items of income, as sufficient items of income are available in year 6, when the accumulated preferred return is paid.

In year 3, the partnership accrues a $121,000 preferred return to Clytaemnestra. The partnership actually distributes $40,000 in cash to Clytaemnestra. This

574 See Treas. Reg. § 1.707-1(c), Example (2) (“Example (2). Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C’s distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.”).
leaves an $81,000 amount of unpaid preferred return for year 3. This amount is payable in a subsequent year. The partnership allocates $20,000 in gross income items to Clytaemnestr. This leaves a $101,000 deficiency for year 3. The deficiency may be reflected as a $101,000 capital shift from Hortense to Clytaemnestr in year 3 or as a $101,000 guaranteed payment in year 3 from the partnership to Clytaemnestr, the special allocation of the $101,000 deduction by the partnership to Hortense, and the reconstitution of $101,000 by Clytaemnestr to the partnership. Perhaps only the $20,000 payment to Clytaemnestr in excess of the $20,000 income allocation to Clytaemnestr should be treated as a guaranteed payment to Clytaemnestr in year 3. The remaining preferred return might be characterized as a guaranteed payment in year 3 or in year 6 or an allocation of items of income in year 6, as sufficient items of income are available in year 6, when the accumulated preferred return is paid.

In year 4, the partnership accrues a $129,100 preferred return to Clytaemnestr. The partnership actually distributes $50,000 in cash to Clytaemnestr. The $79,100 in unpaid preferred return merely accumulates. There is $35,000 in gross income items to allocate to Clytaemnestr. The partnership may shift $94,100 of Hortense’s capital to Clytaemnestr in a taxable capital shift in year 4. A good case can be made for a $15,000 guaranteed payment to Clytaemnestr in year 4, equal to the excess of the preferred return distributed to Clytaemnestr in year 4 over the allocation of gross income items to Clytaemnestr in year 4. The remaining $79,100 preferred return that merely accumulates in year 4 might be treated as a guaranteed payment to Clytaemnestr in year 4, as a guaranteed payment to Clytaemnestr in year 6, or as an income allocation to Clytaemnestr in year 6.

In year 5, the partnership accrues a $137,010 preferred return to Clytaemnestr. The partnership has $90,000 in cash available to make payments on this preferred return. This leaves a $47,010 preferred return accrual from year 4 to be paid in a later year. The partnership has $137,010 in gross income items in year 4 to allocate to Clytaemnestr to match the preferred return accrual in year 4. There should be no capital shift in year 4 and no guaranteed payment. The partnership should allocate $137,010 in gross income items in year 4 to Clytaemnestr.

The partnership sells the property in year 6. The partnership accrues a preferred return of $141,711. The partnership makes a $558,821 cash distribution to Clytaemnestr to pay the current preferred return and all arrearages. The partnership allocates $141,711 in gross income to Clytaemnestr on account of the current preferred return accrual. There should be no guaranteed payments or capital shifts in year 6, except for the possibility that arrearages from earlier years might be treated as guaranteed payments in year 6 (or might be treated as income allocations in year 6).

The tax system might adopt an “open transaction” theory rather than impute either a capital shift or a guaranteed payment. This suggests that the tax sys-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tem might wait until the preferred payment is made until characterizing it as an income allocation or a guaranteed payment or a capital shift. This suggests an alternative to the capital shift or guaranteed payment approach. This “open transaction” method would be similar to the treatment of option payments: the income from the option payment is not recognized until whether the income is capital gain or ordinary income is determined. The capital shift or guaranteed payment would be deferred until the time of the liquidation of the partnership. Under an “open transaction” theory, current capital accounts would not properly reflect how the proceeds of liquidation at “book” value would be distributed until there is a gain allocation on liquidation, a guaranteed payment to Clytaemnestra at liquidation, or a capital shift at liquidation. Gross income should be allocated to Clytaemnestra to the extent of partnership gross income until gross income allocations equal the total preferred return accrued to date. All losses would be allocated to Hortense. This procedure sets capital accounts as close to consistent with how the partnership would liquidate in a liquidation in accordance with capital accounts as is possible. This process would continue until allocations of gross income to Clytaemnestra equal the total preferred return accrued over time. There would be a capital shift from Hortense to Clytaemnestra or a guaranteed payment to Clytaemnestra equal to the amount of the deficiency if there is not sufficient gross income to allocate to Clytaemnestra in the partnership’s taxable year of liquidation of the partnership. This chart shows how gross income might be allocated to Clytaemnestra to support the preferred return:

<table>
<thead>
<tr>
<th>Year</th>
<th>Unreturned Capital</th>
<th>Preferred Return Accrual to Clytaemnestra</th>
<th>Preferred Cash Distribution to Clytaemnestra</th>
<th>Unpaid Preferred Return Accrual to Clytaemnestra for this Year</th>
<th>Gross Income Allocated to Clytaemnestra for Current Preferred Return Accrual</th>
<th>Gross Income Allocated to Clytaemnestra for Past Preferred Return Accrual</th>
<th>Total Preferred Return Income Allocated to Clytaemnestra for Past Preferred Return Accrual</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$0</td>
<td>$100,000</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>$1,100,000</td>
<td>$110,000</td>
<td>$0</td>
<td>$110,000</td>
<td>$10,000</td>
<td>$0</td>
<td>$10,000</td>
</tr>
<tr>
<td>3</td>
<td>$1,210,000</td>
<td>$121,000</td>
<td>$40,000</td>
<td>$81,000</td>
<td>$20,000</td>
<td>$0</td>
<td>$20,000</td>
</tr>
<tr>
<td>4</td>
<td>$1,291,000</td>
<td>$129,100</td>
<td>$50,000</td>
<td>$79,100</td>
<td>$35,000</td>
<td>$0</td>
<td>$35,000</td>
</tr>
<tr>
<td>5</td>
<td>$1,370,100</td>
<td>$137,010</td>
<td>$90,000</td>
<td>$47,010</td>
<td>$137,010</td>
<td>$20,000</td>
<td>$157,010</td>
</tr>
<tr>
<td>6</td>
<td>$1,417,110</td>
<td>$141,711</td>
<td>$558,821</td>
<td>$0</td>
<td>$141,711</td>
<td>$375,100</td>
<td>$516,811</td>
</tr>
<tr>
<td>Total</td>
<td>$738,821</td>
<td>$738,821</td>
<td>$738,821</td>
<td>$738,821</td>
<td>$738,821</td>
<td>$738,821</td>
<td>$738,821</td>
</tr>
</tbody>
</table>

The partnership accrues a $100,000 preferred return to Clytaemnestra in year 1. No cash flow is available to pay Clytaemnestra’s accrued preferred return in year 1. No gross income is available to allocate to Clytaemnestra. This could create an accumulated income deficiency of $100,000 (the amount of the cumulative preferred return in excess of corresponding income allocations on account of the preferred return). This deficiency would not create immediate tax consequences under the “open transaction” theory. Presumably all losses are allocated to Hortense. The partnership might liquidate at “book” value at the end of year 1.
Hortense would bear Clytaemnestra’s preferred return from her unreturned capital. This suggests that any gross income should be allocated to Clytaemnestra and any losses should be allocated to Hortense so that (to the extent possible) the capital accounts are in accordance with the economic priorities of the partnership agreement.

No cash is available in year 2 to pay the preferred return. The partnership has $10,000 in items of gross income. All of this gross income is allocated exclusively to Clytaemnestra. This income allocation is less than the annual accrual of the preferred return. This increases the accumulated income deficiency. A payment of less than the annual accrual is made to Clytaemnestra in year 2. Any gross losses are allocated to Hortense.

The partnership accrues a $121,000 preferred return to Clytaemnestra in year 3. The partnership allocates $20,000 in items of gross income to Clytaemnestra in year 3. The income deficiency increases the accumulated income deficiency. Any gross losses are allocated to Hortense.

The partnership accrues a $129,100 preferred return to Clytaemnestra in year 4. The partnership allocates $35,000 in gross income to Clytaemnestra on account of the preferred return. The income deficiency for the partnership’s taxable year increases the accumulated income deficiency. Any gross losses are allocated to Hortense.

The partnership accrues a $137,010 preferred return to Clytaemnestra in year 5. The partnership allocates $137,010 in gross income to Clytaemnestra on account of the preferred return. The partnership allocates $20,000 in gross income to Clytaemnestra on account of the accumulated income deficiency. The accumulated income deficiency increases. Any gross losses are allocated to Hortense.

The partnership accrues a $141,711 preferred return to Clytaemnestra in year 6. The partnership allocates $141,711 in gross income to Clytaemnestra on account of the year 6 preferred return and $375,100 to Clytaemnestra on account of the accumulated income deficiency. Income and losses should be allocated so that liquidating distributions (in accordance with the liquidating scheme in the partnership agreement) will zero out capital accounts.

It is possible that Section 721 applies to the capital shift. Section 721 may protect the partners and the partnership from recognizing gain when there is a capital shift incident to a capital contribution. This proposition has not yet been properly tested in the courts.

Distribution provisions based on achieving a specified internal rate of return easily can result in unanticipated tax results. Distributions may be made like this:
(a) First, all cash will be distributed to Dick. This distribution shall continue under this Section x.(a) while\(^575\) the amount of cash that has been distributed to Dick under this Section x(a) gives Dick an Internal Rate of Return less than a 10% Internal Rate of Return (counting only distributions under Section x(a)).

(b) Second, all remaining distributions of cash will be made 50% to Dick and 50% to Bill if the distributions to Dick under Section x(a) have been sufficient to give Dick an Internal Rate of Return equal to or greater than a 10% Internal Rate of Return (counting only distributions under Section x(a)).

This provision applies for operating distributions, for distributions from sale, and for liquidating distributions. The partnership does not explicitly liquidate by capital accounts.

The partnership has a net loss in year 1. No distributions are made to either partner.

The partnership might sell its assets for adjusted tax basis (“book” value) and distribute the proceeds of liquidation at the end of year 1. All cash would be distributed to Dick under Section x(a) until Dick received a 10% internal rate of return (counting only distributions under Section x(a)).\(^576\)

Bill’s capital contribution would bear the economic burden of the return to Dick – at least if there were a liquidation at the end of year 1. This suggests the possibility of a capital shift (perhaps a taxable capital shift) from Bill to Dick in year 1. (Other possibilities include a guaranteed payment and a possible capital shift at time of liquidation.) Dick would receive more than his capital account and Dick would receive less than his capital account if the partnership liquidated at “book” value.

Internal-rate-of-return-based agreements frequently create the possibility of taxable shifts of capital from one partner to another. At the end of a taxable year of normal operations, you often do not know whether the return will be a dis-

\(^575\) If you use “until” rather than “while,” clarify whether the tier is retested every year, or whether the test, once met, is treated as met forever.

\(^576\) Another variant of this example is when Bill guarantees that Dick will receive distributions sufficient to give Dick an x% internal rate of return (with Bill agreeing to make up the difference).

These examples might differ materially if the partnership agreement contained a “clawback” under which Dick were forced to disgorge distributions borne out of Bill’s capital if there were not sufficient income allocations to Dick prior to the completion of liquidating distributions.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tribution of partnership profits. The problem is that you really do not know until the liquidation of the partnership whether the return is paid out of capital or represents purely a share of partnership profits. Profit and loss allocations, however, are based on the annual taxable year.

Where the preferred return is preferred to capital distributions to the other partners, the tax laws might treat any accruing preferred return that exceeds current profits as a capital shift to the partner receiving the preferred return (borne by the partners whose capital would suffer impairment). The key is that the partnership does not liquidate in accordance with stated capital accounts, but rather the partnership is liquidated by specified tiers (that do not permit liquidation in accordance with capital accounts under the assumed facts).

The tax consequences of the distribution scheme are not well determined. One possible result is that this distribution scheme creates a presumably taxable capital shift from Bill to Dick during year 1. The partnership might have gross income and loss items in year 1. The economic situation then might require deemed special allocations of gross losses and gross income to create the same result as a capital shift between partners. Another possibility is that some of the return to Dick might be treated as a guaranteed payment under Section 707(c). The guaranteed payment amount might be all of the return to Dick beyond the return of his capital contribution, or it might be the return to Dick in excess of the sum of Dick’s capital contribution plus profits (perhaps net profits, perhaps gross income items) than can be allocated to Dick. The guaranteed payment could be treated as accruing either on a day-by-day basis or on the last day of the partnership’s taxable year. It would seem in either case that Dick could be taxable even though the partnership is a cash method partnership and Dick has not received cash payments. (The guaranteed payment of a cash method partnership could be treated as occurring currently or perhaps when the actual payment is made.) The shift in capital would be treated as the payment to Dick. Dick could be taxable currently, even though Dick receives no distributions under the internal-rate-of-return tier currently. (The total guaranteed payment amount to Dick should be limited to no greater than the amount of Bill’s capital contribution (plus any other increases to Bill’s capital account).)

---

577 See, for example, Prop. Treas. Reg. § 1.721-1(b)(4)(i) (“To the extent that a partnership interest is – (i) Transferred to a partner in connection with the performance of services rendered to the partnership, it is a guaranteed payment for services under section 707(c) . . . .”).

578 See, generally, Treas. Reg. § 1.707-1(c). This Treasury Regulation contains these examples:

(footnote continued on the next page)
Another possibility is that the transaction should be treated as a guaranteed payment to Dick equal to the accrued return in excess of current gross income, an allocation of the deduction to Bill, and a deemed recontribution of the return by Dick to the partnership.\footnote{579}

Partnership case law, statutory law and administrative law are not sufficiently well determined so that the tax treatment of potential capital shifts is clear.

---

**Example (1).** Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

**Example (2).** Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than $10,000. The income of the partnership is $60,000, and C is entitled to $18,000 (30 percent of $60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of $20,000 instead of $60,000, $6,000 (30 percent of $20,000) would be partner C’s distributive share, and the remaining $4,000 payable to C would be a guaranteed payment.

**Example (3).** Partner X in the XY partnership is to receive a payment of $10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of $10,000 to partner X, the XY partnership has a loss of $9,000. Of this amount, $2,700 (30 percent of the loss) is X’s distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of $10,000 made to him by the partnership.

**Example (4).** Assume the same facts as in example (3) of this paragraph, except that, instead of a $9,000 loss, the partnership has $30,000 in capital gains and no other items of income or deduction except the $10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a $10,000 ordinary loss and $30,000 in capital gains. X’s 30 percent distributive shares of these amounts are $3,000 ordinary loss and $9,000 capital gain. In addition, X has received a $10,000 guaranteed payment which is ordinary income to him.

This is suggested by Treas. Reg. § 1.707-1(c), Example (2), quoted in note 578.
Whether the distribution satisfying the preferred interest is paid out of the other partner’s capital until the partnership has wound up is not clear under partnership case law, statutory law and administrative law. Treasury Regulations governing allocations of partnership tax items (Section 704(b)) are based on an annual year concept and do not explicitly address what happens when events in years 2, 3, or 4 may affect how the economic profits of year 1 are allocated among the partners. There may be a capital shift at the end of each year during which the preferred return accrues (at least when the return exceeds the profit allocation to the partner). This capital shift at the end of each year would be consistent with the idea that capital accounts accurately mirror (on a real time basis) how the proceeds of liquidation would be allocated among the partners based on a sale of partnership assets for “book” value and distribution of the proceeds. Allocations should adjust the partnership capital accounts so that, if the partnership sold its assets for the “book” value of those assets, paid off all debts, and liquidated, distributing the proceeds in accordance with positive capital account balances, each partner would be left with a zero capital account at the end of the day.580 A capital shift (or a special allocation of items of gross income – or perhaps a combination of the two – or perhaps a guaranteed payment – perhaps in combination with a special allocation of items of gross income) may be necessary in order for capital accounts properly to reflect partnership economics on a real time basis.

Any capital shift might be deferred until the winding up of the partnership – perhaps under an “open transaction” theory. Whether the return is payable out of another partner’s capital is contingent until that partnership winds up. A reasonable argument could be made for “open transaction” principles. The partners do not know in the earlier year whether another partner’s capital will bear the preferred return or whether the preferred return will be paid out of economic profits. A court might determine that only at liquidation of the partnership is it resolved whether the return is paid out of profits or the other partner’s capital account and therefore the capital shift (if any) should be deferred until the winding up and liquidation of the partnership. Courts have not properly engaged the issues raised by this problem. These issues are not adequately dealt with under current Treasury Regulations.

The partnership tax laws concerning potential shifts in capital have not been definitively resolved. Until that resolution, any transaction involving a potentially significant capital shift should be treated as having indeterminate tax results. You can avoid capital shifts by making judicious use of special allocations of partnership gross income, coupled with limiting the partner to receiving the

---

580 See discussion of Target Capital Accounts in the text accompanying note 596.
amount in his capital account on partnership liquidation. A partnership typically will have enough gross income to avoid capital shifts. Also, a partnership agreement typically can avoid capital shifts by distributing proceeds of liquidation in accordance with capital account balances at liquidation.

### 62. Allocations of Partnership Income and Losses.

Drafting complicated allocations of taxable income and taxable loss (or allocations of Net Profits and Net Losses) requires skill that usually is derived from experience. The key to drafting allocations of income and loss is to ensure that these allocations correspond to the economics of the partnership. Be cautious that allocations of taxable income and taxable loss either must have “substantial economic effect” or must be “in accordance with the partner’s interest in the partnership.”

Tax rules governing partnership allocations are complex, pointillist, and stochastic. The rules are complex in the sense that the text of Treasury Regulations is long, difficult to understand, and bewildering to read. Few partnership tax specialists are masters of the rules of substantial economic effect. The rules are pointillist in the sense that regulations, cases, and administrative authority are a set of dots; they address a number of limited situations. Many situations are not directly addressed by Treasury Regulations. You must generalize from the pointillist dots to see the full picture. The rules are stochastic in the sense that many of the rules cannot be applied with mathematical precision. Draftsmen can apply tax rules only in terms of probabilities of a particular answer being correct. There is considerable uncertainty built into the partnership tax rules. New partnership tax rules often address problems in terms of probability.

Understand “minimum gain chargeback,” “partner nonrecourse debt minimum gain chargeback,” “qualified income offset,” “nonrecourse deductions,” “partner nonrecourse deductions,” “exculpatory deductions,” and similar partnership tax concepts if you are drafting allocations in most real estate partnership agreements.

Allocations of partnership income and taxable loss should accord with partnership economics. Allocations often adjust capital accounts so that each

---

581 Partnership agreements often allocate net “book” income and net “book” loss. These items are defined under principles of the capital account maintenance Treasury Regulations found at Treas. Reg. § 1.704-1(b)(2)(iv). In addition to considerations discussed in this Article, allocations must pass through the additional test of “substantiality.”
partner will receive the amount in the partner’s capital account on retirement or liquidation from the partnership. The income and loss allocations are tied to and parallel the general economic deal. The capital accounts actually express the final economic deal if the partnership liquidates in accordance with final capital accounts. Income and loss allocations express the final economic deal if the partnership liquidates by capital accounts. Income and loss allocations determine capital accounts. Capital accounts determine how cash is distributed if the partnership liquidated in accordance with positive capital accounts. Income and loss allocations should parallel partnership economics regardless of whether your partnership agreement explicitly distributes the proceeds of liquidation in accordance with capital accounts.

Draft these income and loss allocations carefully so that capital accounts and cash distributions will agree so as to “zero out” each partner’s capital account by the time of liquidation. Run comprehensive numerical examples (or cause the partnership accountants or financial advisors to run comprehensive numerical examples) to ensure that allocations are correct.582


Partnership agreements often net operating income and operating losses into Net Losses and Net Profits. These are “book” income and losses.583 Net Losses and Net Profits are defined purely by reference to “book” income and loss allocations when there is a difference between “book” items and tax items. Your partnership will have either (but not both) Net Losses or Net Profits in any particular year. Your partnership should not have both Net Losses and Net Profits in the same fiscal period. Net Losses often are defined to exclude nonrecourse deduc-

582 Some inexperienced draftsmen (and many inexperienced corporate and real estate lawyers) feel that allocations of income and loss are nothing but tax mumbo-jumbo. A partner can be bankrupted by tax liability resulting from allocations of partnership income without corresponding distributions. An example is where some but not all partners contribute capital, capital is returned prior to other distributions, and service partners share from the beginning in allocations of income. Spreadsheet examples are critical to understanding the operation of anything but the simplest partnership agreement.

583 Excel® is an essential tool in drafting partnership allocations. Excel® should be the draftsman’s constant companion. If you do not have proficiency with Excel® or some comparable software product, gain that proficiency. The draftsman is at a substantial disadvantage if he is unable to use either Excel® or some comparable software product. Work particularly carefully with partnership accountants in the interim.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tions and partner nonrecourse deductions. Those categories of deductions generally are allocated under separate provisions of the partnership agreement and are charged back by the minimum gain chargeback or partner nonrecourse debt minimum gain chargeback. Loss items included in computing Net Losses could be considered recourse losses – losses attributable to capital contributions and recourse debt. Net Losses and Net Profits may include exculpatory deductions. 584

Net Losses perhaps first will be allocated to partners in accordance with Percentage Interests. Net Losses often will be allocated first to partners with positive capital accounts. This allocation might be made in accordance with positive capital account balances, positive Adjusted Capital Account balances, or some other ratio (for example, defined percentage interests). Net Losses often are allocated first to charge back or to reverse prior Net Profits allocations. This is an example of many provisions for allocations of Net Losses:

Section x.x Allocation of Net Loss. The Partnership shall allocate Net Loss for each Fiscal Year to the Partners in accordance with this order of priority (with the test of each tier to be reapplied (independent of prior satisfaction of this test) whenever this Section x.x is applied):

(a) Net Loss up to the excess (if any) of –

(i) The aggregate Net Profit allocated under Section y.y(c) for any prior Fiscal Year over

(ii) The sum of –

(A) The aggregate Net Loss previously allocated under this Section x.x(a) and

(B) The aggregate amount previously allocated under Section z.z(a),

shall be allocated to the Partners in proportion to the ratio of these excesses computed for each Partner. This allocation shall be made under this Section x.x(a) while any Partner has a positive excess.

(b) Any remaining Net Loss shall be allocated to the Partners having positive Adjusted Capital Account balances. This allocation shall be made under Section x.x(b) to these Partners in proportion to their Adjusted Capital Account balances. This allocation shall be made under Sec-

584 See discussion in text accompanying note 900. See discussion of exculpatory deductions in text at notes 36 and 370. See discussion of Net Profits and Net Losses in text accompanying notes 529.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tion x.x(b) while there are any Partners with positive Adjusted Capital Account balances.

(c) Any remaining Net Loss shall be allocated to the Partners in proportion to their Percentage Interests.\textsuperscript{585}

The allocation of Net Losses often is limited so that no partner receives an allocation that will create or increase an Adjusted Capital Account Deficit. This limitation corresponds to the limitation that is imposed under the alternate test for economic effect.\textsuperscript{586}

b. Net Profits.

Allocations of operating income (Net Profits) often reverse prior loss allocations, then follow the accrued preferred return, and then follow Percentage Interests. Net Profits are “book” gain and income.\textsuperscript{587} Do not to reverse prior allocations of nonrecourse deductions with allocations of operating income. This makes no economic sense at all. Nonrecourse deductions will be reversed by allocations under the minimum gain chargeback. Partner nonrecourse debt losses are reversed by gain allocations under the partner nonrecourse debt minimum gain chargeback. An operating income allocation that reverses prior nonrecourse deductions will create a double chargeback.

c. Tiered Allocations.

Section x.x. Net Profits. The Partnership shall allocate Net Profits for each Fiscal Period of the Partnership in accordance with this order of priority:

(a) First, the Partnership shall allocate Net Profits exclusively to Partner X. This allocation shall be made under this Section x.x(a) until Partner X has received an allocation of Net Profits under this Section x.x(a) in an amount equal to Partner X’s accrued Preferred Return.

(b) Second, the Partnership shall allocate any remaining Net Profits 50% to Partner X and 50% to Partner Y.\textsuperscript{588}

\textsuperscript{585} In many partnership agreements, although there typically is a final tier of Net Loss allocated in accordance with Percentage Interests, you can never actually get there. Once Adjusted Capital Accounts are reduced to era, further Net Loss allocations may only be from liabilities, which are carved out from the definition of Net Loss and are allocated under special allocation rules.

\textsuperscript{586} See discussion in text accompanying note 1049.

\textsuperscript{587} See discussion of “book” items in text accompanying note 9.

\textsuperscript{588} Note that this provision does not charge back prior Net Losses.
**SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS**

Each tier of allocation of Net Profits, when there is a separate provision that allocates net gain from sale, should be coordinated with the allocation of net gain from sale. The allocation equal to the preferred return might be made from either of net profits or gain from sale or a combination of both. The provision might be drafted:

*Section x.x. Net Profits. The Partnership shall allocate Net Profits for each Fiscal Period of the Partnership in accordance with this order of priority:

(a) First, the Partnership shall allocate Net Profits exclusively to Partner X. This allocation shall be made under this Section x.x(a) until (i) Partner X has received an allocation of Net Profits under Section x.x and Net Gain from Sale under Section y.y in an aggregate amount equal to (ii) Partner X’s accrued Preferred Return.

(b) Second, the Partnership shall allocate any remaining Net Profits 50% to Partner X and 50% to Partner Y.*

This paragraph has several defects. First, an allocation of Net Profits is unlikely to be precisely equal to the amount of Partner X’s accrued Preferred Return. The allocation of Net Profits may be close to the amount of Partner X’s accrued Preferred Return. The allocation is unlikely to be precisely equal to this accrued Preferred Return. Second, there is ambiguity concerning what happens once the test in paragraph (a) is satisfied. There is ambiguity concerning whether the condition in paragraph (a) should be retested each fiscal period (or whether, once the condition has been satisfied, the condition should be treated as satisfied forever). There is ambiguity concerning whether prior-year allocations under paragraph (b) are treated as satisfying the condition in paragraph (a).

A better formulation might be:

*Section x.x. Net Profits. The Partnership shall allocate Net Profits (for each Fiscal Period of the Partnership) in this order of priority (with the test of each tier to be reapplied (independent of prior satisfaction of this test) whenever this Section x.x is applied):

(a) First, the Partnership shall allocate Net Profits exclusively to Partner X. The allocation shall be made under this Section x.x(a) while (i) the aggregate allocations of Net Profits under this Sec-

---

589 Note that this provision does not charge back prior Net Losses.
590 When you use “until” rather than “while,” clarify whether the tier is retested every year, or whether the test, once met, is treated as met forever.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

tion \(x.x(a)\) and Net Gain from Sale under Section \(y.y(a)\) are less than (ii) Partner X’s accrued Preferred Return. 591

(b) Second, the Partnership shall allocate any remaining Net Profits 50% to Partner X and 50% to Partner Y. 592

This formulation clarifies several matters. The test is satisfied on moving from below to being equal to or greater than the accrued Preferred Return. This eliminates the ambiguity created by the use of “equals.” Second, this formulation clarifies that the test in paragraph (a) is reapplied each fiscal period independent of the possibility that the test was satisfied in a prior fiscal period. Third, this formulation clarifies that prior allocations under Section \(x.x(b)\) are not considered in satisfying the test under Section \(x.x(a)\).

Net Profits sometimes charge back prior Net Losses on a tier-by-tier basis. This is an example:

Section \(x.x\). Allocation of Net Profits. The Partnership shall allocate Net Profits (for each Fiscal Year of the Partnership) to the Partners in accordance with this order of priority. The test in each subparagraph to be reapplied whenever this Section \(x.x\) is applied:

(a) First, the Partnership shall allocate Net Profits to the Partners up to the excess (if any) of (i) the aggregate Net Losses allocated under Section \(y.y(c)\) for any prior Fiscal Year over (ii) the aggregate Net Profits previously allocated under this Section \(x.x(a)\). This allocation under Section \(x.x(a)\) shall be made in proportion to the ratio of these excesses computed for each Partner.

(b) Second, the Partnership shall allocate remaining Net Profits to the Partners up to the excess (if any) of (i) the aggregate Net Losses allocated under Section \(y.y(b)\) for any prior Fiscal Year over (ii) the aggregate Net Profits previously allocated under this Section \(x.x(b)\). This allocation under Section \(x.x(b)\) shall be made to the Partners in proportion to the ratio of these excesses computed for each Partner.

(c) Finally, the Partnership shall allocate any remaining Net Profits to the Partners in proportion to their Percentage Interests.

Be constantly vigilant to create your own formulation of allocations that express your allocations more effectively.

591 Note that this provision does not charge back prior Net Losses.
592 Note that this provision does not charge back prior Net Losses.
d. “Layer Cake” Allocations.

One common drafting technique uses “layer cake” allocations. This technique makes allocations to build up the partners’ Adjusted Capital Accounts to reach target levels. These provisions are particularly used in allocating gain or loss from sale of the principal partnership assets.

These provisions should consider later allocations under the minimum gain chargeback and the partner nonrecourse debt minimum gain chargeback. Consider introducing Adjusted Capital Account, often defined as the partner’s capital account increased by the partner’s share of minimum gain (or potential gain allocation under the minimum gain chargeback) and the partner’s share of partner nonrecourse debt minimum gain (or potential gain allocation under the partner nonrecourse debt minimum gain chargeback).

“Layer cake” allocations often start by eliminating negative Adjusted Capital Accounts. “Layer cake” allocations then often build up Adjusted Capital Accounts until the Adjusted Capital Accounts equal unrecovered capital. The “layer cake” allocations then often build up Adjusted Capital Accounts until the Adjusted Capital Accounts equal the sum of unrecovered capital plus preferred returns. The “layer cake” allocations then often allocate by percentage interests. Layer cake allocations can be used to adjust Adjusted Capital Accounts to make highly complex tiered arrangements.

A plan of allocations following this scheme might provide:

Section x.x. Net Gain from Sale. The Partnership shall allocate Net Gain from Sale in accordance with this order of priority. The test in each subsection to be reapplied (independent of prior satisfaction of this test) whenever this Section x.x is applied:

(a) First, the Partnership shall allocate Net Gain from Sale to Partners with negative Adjusted Capital Accounts. These allocations shall be made under Section x.x(a) while any Partner has a negative Adjusted Capital Account. This Net Gain from Sale shall be allocated among these Partners in accordance with the ratio of their negative Adjusted Capital Accounts,

(b) Second, the Partnership shall allocate remaining Net Gain from Sale to Partners with Unrecovered Capital Contributions that are in excess of their Adjusted Capital Accounts. These allocations shall be made under Section x.x(b) while any Partner has an Unrecovered Capital Con-

593 When you use “until” rather than “while,” clarify whether the tier is re-tested every year, or whether the test, once met, is treated as met forever.
A net gain from sale shall be allocated among these Partners in accordance with the ratio of these excesses.

(c) Third, the Partnership shall allocate remaining Net Gain from Sale to the Partners for whom the sum of the Partner’s Unrecovered Capital Contribution and the Partner’s Unpaid Preferred Return is in excess of the Partner’s Adjusted Capital Account. These allocations shall be made under Section x.x(c) while there are any Partners for whom the sum of the Partner’s Unrecovered Capital Contribution and the Partner’s Unpaid Preferred Return is in excess of the Partner’s Adjusted Capital Account. This Net Gain from Sale shall be allocated among these Partners in accordance with the ratio of these excesses.

(d) Fourth, the Partnership shall allocate any remaining Net Gain from Sale to the Partners in accordance with their Percentage Interests.

This “layer cake” allocation of gain from sale follows a common pattern. “Layer cake” allocations are more common for allocations of gain from sale or gain from liquidation than income from operations – although they may be used for allocation of income from operations.

The allocation of Net Gain from Sale first eliminates deficit Adjusted Capital Accounts. This allocation of Net Gain from Sale will eliminate concern over deficit restoration obligations. This first tier allocation has the effect of reversing prior recourse loss allocations (or distributions) that created deficit Capital Accounts.

Then ask yourself: if there is any cash available to the partners from proceeds of liquidation, how should the partnership distribute that cash first? The answer for most partnerships is that the first cash goes to reimburse unrecovered capital contributions (Unrecovered Capital Contributions). The second tier allocation of Net Gain from Sale therefore adjusts Adjusted Capital Accounts until the Adjusted Capital Accounts equal Unrecovered Capital Contributions. The partnership might distribute cash from liquidation by Capital Accounts immediately after this second tier allocation of Net Gain from Sale. The partnership would distribute to partners the amounts of their Unrecovered Capital Contributions.

Ask yourself: how should the partnership distribute cash next? A common answer is that the next cash priority is the preferred return (Unpaid Preferred Return). The third tier allocation of Net Gain from Sale adjusts Adjusted Capital Accounts until the Adjusted Capital Accounts equal the sum of the partners’ Unrecovered Capital Contributions and Unpaid Preferred Returns. The partnership might distribute cash from liquidation by Capital Accounts immediately after this third tier allocation of Net Gain from Sale. The partnership would distribute to
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

partners the amounts of their Unrecovered Capital Contributions and their Unpaid Preferred Returns. This third tier allocation of Net Gain from Sale permits the partnership, distributing the proceeds of liquidation in accordance with Capital Accounts, to return Unrecovered Capital Contributions and then to pay Unpaid Preferred Returns.

This scheme can be continued for as many tiers of allocations as tiers of distributions. The final tier normally is an allocation by percentage interests.

As a general matter, there is a close correspondence between tiers for allocations of Net Gain from Sale and tiers for distributing cash from capital events.

The “layer cake” allocation operates on Adjusted Capital Accounts rather than Capital Accounts. The two terms will be equal after the partnership recognizes and reverses all minimum gain and partner nonrecourse debt minimum gain. Use of “Adjusted Capital Account” makes provision for the later application of the minimum gain chargeback and the partner nonrecourse debt minimum gain chargeback. You might design your Net Gain from Sale allocations to operate directly on Capital Accounts. Where there is latent minimum gain that has not yet been recognized, the later recognition of the latent minimum gain can disrupt Capital Account values and can distort the economic scheme.

You can construct a similar “layer cake” of allocations of Net Losses.

The allocations in the sample provision use “while” rather than “until.” This avoids the ambiguity created by “until” concerning whether the condition in a tier is retested each time the Net Profits allocation provision is applied – or whether the tier is satisfied forever once the condition is satisfied.

“Adjusted Capital Accounts” are equal to –

- The partner’s Capital Account increased by
- The partner’s share of minimum gain [or the potential amount allocable to the partner under the minimum gain chargeback] and increased by
- The partner’s share of partner nonrecourse debt minimum gain [or the potential amount allocable to the partner under the partner nonrecourse debt minimum gain chargeback] and anticipated allocations to the partner under the qualified income offset.

---

594 The qualified income offset applies so infrequently that it is a matter of professional judgment whether to make the adjustment for anticipated allocations under the qualified income offset.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Adjusted Capital Accounts might be adjusted by potential gain under a qualified income offset. Whether that makes sense is debatable. The qualified income offset usually does not have much gain latency. The qualified income offset is dependent on unexpected events.

The use of Adjusted Capital Accounts in drafting “layer cake” allocations is preferable to the direct use of Capital Accounts. This takes into account the possibility that there may be a lurking allocation under the minimum gain chargeback or the partner nonrecourse debt minimum gain chargeback that may later distort partnership allocations. Layer cake allocations that adjust Capital Accounts rather than Adjusted Capital Accounts frequently produce erroneous results.

When the “layer cake” allocations are completed, it should be possible to distribute to each partner the amount in the partner’s Capital Account. The “layer cake” approach has the effect of adjusting Capital Accounts so that the Capital Accounts will conform to the economic scheme for distributing proceeds on liquidation.

e. Target Allocations.

Section x.x Allocation of Net Profits and Net Losses. The Partnership shall allocate Net Income or Net Losses for each Fiscal Period of the Partnership to the Partners in a manner so that (at the end of the Fiscal Period) –

(a) The Capital Account (adjusted by gain that would be recognized on a hypothetical liquidation of the Partnership) of each Partner shall equal –

(b) The amount that would have been distributed to the Partner under a hypothetical liquidation under Section y.y.

For this purpose, a “hypothetical liquidation of the Partnership” means the sale of all of the assets of the Partnership in a taxable disposition for the “book” value of these assets (using “book” in the sense in which that term is used in Treasury Regulations Section 1.704-1(b)(2)(iv)), the debts of the Partnership are paid, and the remaining amounts are distributed to the Partners in liquidation under Section y.y. Each Partner’s Capital Account shall be hypothetically adjusted as if the liquidating sale has occurred during the Fiscal Period.

This is an alternative formulation:

Section x.x Allocation of Net Profits and Net Losses. The Partnership shall allocate Net Profits and Net Losses for each Fiscal Period of the Partnership in a manner so that (at the end of the Fiscal Period) the sum of –
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(a) The Capital Account of each Partner (as adjusted under this Section x.x),
(b) The Partner’s share of Partnership Minimum Gain
(c) The Partner’s share of Partner Nonrecourse Debt Minimum Gain, and
[(d) The Partner’s share of Exculpatory Liability Minimum Gain,]
shall equal the net amount that would have been distributed to the Partner under a hypothetical liquidation of the Partnership.

For this purpose, a “hypothetical liquidation of the Partnership” means that

(a) All assets of the Partnership are disposed of in a taxable disposition for the “book” value of the assets (using “book” in the sense in which “book” is used in Treasury Regulations Section 1.704-1(b)(2)(iv));
(b) The debts of the Partnership are paid; and
(c) The remaining amounts are distributed to the Partners under Section y.y.

Each Partner’s Capital Account shall be hypothetically adjusted as if the liquidating sale has occurred during the Fiscal Period.

This is another similar formulation:

Section x.x. Allocation of Net Profits and Net Losses. The Partnership shall allocate Net Profits first to the Partners having Adjusted Capital Account Deficits (computed after making Distributions under Section y.y with respect to the Fiscal Year) in proportion to, and to the extent of, their Adjusted Capital Account Deficits. Any remaining Net Profits or (as the case may be) any Net Losses shall be allocated among the Partners so as to produce Capital Accounts for the Partners (computed assuming that all Partnership Assets are sold for an amount equal to their “book” value (using “book” in the sense in which “book” is used in Treasury Regulations Section 1.704-1(b)(2)(iv)) (or, if greater, the amount of nonrecourse liabilities secured by these assets) and after crediting to each Partner’s Capital Account the Partner’s share of income or gain that would be realized on these sales) so that, if an amount of cash equal to the positive Capital Account balances were distributed in accordance with the positive Capital Account balances, the distribution would be in the amounts, sequence and priority set forth in Section y.y. To the extent that an allocation of Net Losses exceeds the positive Adjusted Capital Account balances
of the Partners, the excess shall be allocated in accordance with the Partners’ Percentage Interests.

This is another alternative formulation:

Section x.x. Allocation of Net Profits and Net Losses. After giving effect to the special allocations set forth in Section y.y, Net Profits and Net Losses with respect to any Fiscal Period shall be allocated to the Members as follows:

(a) First, Net Profits shall be allocated to those Members having deficit balances in their Capital Accounts (computed after taking into account all distributions with respect to such taxable period and after adding back each Member’s share of Company Minimum Gain and Member Minimum Gain) in proportion to such deficit balances until such deficit balances have been eliminated.

(b) Second, any remaining Net Profits or Net Losses shall be allocated among the Members in such manner so that, after such allocation, each Member’s Capital Account balance (computed after taking into account all distributions and increased by such Member’s share of Company Minimum Gain and Member Minimum Gain), as nearly as possible, would be equal to the amount that each Member would receive if all of the assets of the Company were sold for an amount equal to their Book Value, all liabilities of the Company were satisfied (limited, with respect to Nonrecourse Liabilities, to the Book Value of the assets securing these Nonrecourse Liabilities) and the remaining assets were distributed pursuant to Section z.z of the Agreement.

You may be uncomfortable distributing proceeds of liquidation in accordance with capital account balances. You may be uncomfortable with your ability to anticipate capital account adjustments. That is fine. Define specific tiers of distributions and then allocate income and gain so that capital accounts are adjusted in accordance with the distribution scheme. That is the operation and theory of target allocations.\footnote{There is no formalized commonly-accepted terminology for this scheme of allocations. Some practitioners refer to “target allocations.” Some practitioners refer to “target capital accounts.” Some practitioners refer to “targeted allocations.” Some practitioners refer to “cash is king partnership agreements.” Some practitioners refer to “forced allocations.” Some practitioners refer to “fill-up” allocations. Some practitioners refer to “distribution driven agreements.”}

Target allocations can be used by inexperienced draftsmen generally with reasonably satisfactory results. The target allocations nevertheless can mask seri-
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

ous tax issues that you and your client should consider. Target allocations sometimes will aid experienced draftsmen in difficult drafting situations (for example, drafting allocations where distribution tiers are based on internal rates of return).

Target allocations are the current rage, a rage accompanied by perils. Target allocations abdicate control over partnership allocations and too often abdicate reasoned thought over how partnership items should be allocated among partners. Many target allocation provisions are as badly drafted as the first example above. Target allocations can be a useful tool in the sophisticated draftsmen’s toolbox, to be used when appropriate. Target allocations are widely used by inexperienced and unskilled draftsmen as Angus MacGyver would use duct tape and his jack-knife – as a solution for every drafting challenge. That is not appropriate. The results of the inexperienced and unskilled draftsmen’s efforts with target allocations can be unsatisfactory when target allocations mask more serious tax issues.

Some advisors feel that the target allocation approach is a panacea for all partnerships and all situations. Target allocations [usually] produce mathematically “correct” results over the life of the partnership (without considering timing or character), although they provide inadequate guidance concerning how non-recourse deductions and partner nonrecourse deductions should be allocated or how depreciation recapture should be allocated. The simplicity of target allocations can be illusory. Target allocations provide a Byzantine way of saying nothing more than Net Profits and Net Losses are allocated as a pool in accordance with Percentage Interests. Whether target allocations will provide the partnership tax accountants with sufficient guidance to complete the partnership’s tax return in more complicated cases will differ from situation to situation and from accountant to accountant. Many accountants may understand allocations under the target allocation provisions as little as the allocations are understood by the attorneys drafting them.

A target allocation appears easy to draft – or easy to duplicate from a prior deal. Target allocations leave all of the work to the partnership accountants. Target allocations may not do the partnership much more good than merely stating that: “Net Profits and Net Losses shall be allocated in accordance with Partners’ interests in the Partnership” or “Accountant, do your thing.” Experience shows that target allocations are often drafted sloppily. The partnership agreement often omits the minimum gain chargeback, partner nonrecourse debt minimum gain chargeback, and qualified income offset and included items that should be allocated under these provisions in the target income allocation. The target allocations often fail to adjust Capital Accounts by minimum gain and by partnership nonrecourse debt minimum gain. Net Profits and Net Losses often are defined carelessly. Partner nonrecourse deductions clearly should not be included in target allocations. Nonrecourse deductions likely should not be included in target allocations. I am bewildered when I read a long target allocation clause when all partnership
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

economics are controlled by a single set of 50/50 percentage interests. The target allocation approach can be a complicated way to say: allocate everything 50/50.

An experienced tax partner at a large regional accounting firm recently shared with me that, when he encountered his first target allocation clause, it nearly knocked him out of his seat. He did not know how to prepare the tax return at all. Target allocation clauses can confuse accountants who are not used to them. Make sure, if you use target allocations, that the accountants understand what to do in completing the partnership tax return. Make sure that your client understands how income and loss will be allocated.

Some draftsmen hope that target allocations (often coupled with liquidation by specified tiers rather than by capital accounts) will satisfy the economic effect equivalence test and may seek to use the economic effect equivalence test as a way to achieve deemed economic effect. The economic effect equivalence test provides: “Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(i) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if requirements (1), (2), and (3) of paragraph (b)(2)(ii)(b) of this section had been satisfied, regardless of the economic performance of the partnership.”

Satisfying the economic effect equivalence test may be important in order to meet the tests of the nonrecourse deduction allocation rules. Whether target allocations (coupled with liquidation by specified tiers rather than by capital accounts) meet the requirements of the nonrecourse deduction allocation rules, however, is unresolved. Some advisors believe that meeting the economic effect equivalence test is enough to satisfy the nonrecourse deduction allocation rules. That is not precisely what the nonrecourse deduction allocation rules say. The nonrecourse deduction allocation rules require that:

- Throughout the full term of the partnership requirements (1) and (2) of section 1.704-1(b)(2)(ii)(b) are satisfied (that is, capital accounts are maintained in accordance with section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either section 1.704-1(b)(2)(ii)(b) or section 1.704-1(b)(2)(ii)(d) is satisfied (that is, partners with deficit capital accounts have an un-

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

conditional deficit restoration obligation or agree to a qualified in-
come offset);

- Beginning in the first taxable year of the partnership in which there
are nonrecourse deductions and thereafter throughout the full term
of the partnership, partnership agreement allocates nonrecourse de-
ductions 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 nonre-
course liabilities;

- Beginning in the first taxable year of the partnership that it has
nonrecourse deductions or makes a distribution of proceeds of a
nonrecourse liability that are allocable to an increase in partnership
minimum gain, and thereafter throughout the full term of the part-
nership, the partnership agreement contains a provision that com-
plies with the minimum gain chargeback requirement; and

- All other material allocations and capital account adjustments u-
der the partnership agreement are recognized under section 1.704-
1(b) (without regard to whether allocations of adjusted tax basis
and amount realized under section 613A(c)(7)(D) are recognized
under section 1.704-1(b)(4)(v)).

The target allocation approach (coupled with liquidation by specified tiers
rather than by Capital Accounts) does not explicitly require that liquidating distr-
ibutions be made in accordance with positive Capital Account balances. Agree-
ments providing for target allocations often (although not invariably) leave out the
qualified income offset and minimum gain chargeback. This creates substantial
doubt that the target allocations will satisfy the nonrecourse deduction allocation
rules. The courts have not yet considered the effect of using target allocations
(coupled with liquidation by specified tiers rather than by Capital Accounts) and
the effect on nonrecourse deduction allocations.

The target allocation approach (without more) provides ambiguous or in-
effective guidance concerning allocating nonrecourse deductions. Nonrecourse
deductions will be allocated “in accordance with the partner’s interest in the part-
nership” if the partnership agreement says nothing more; however, those interests
often are illusive, especially with respect to nonrecourse deductions. The nonre-
course deductions might be allocated pursuant to same ratio of other items under
the target allocation approach, even though the partnership agreement does not
satisfy the tests for allocating nonrecourse deductions. This could provide for an-

597 Treas. Reg. § 1.704-2(e).
nal shifting allocations of nonrecourse deductions to reflect shifting allocations of recourse deductions under the target allocation approach. Failing properly to allocate nonrecourse deductions can be perilous for many real estate partnerships. There can be considerable doubt how nonrecourse deductions are allocated for a partnership that uses this target allocation approach (coupled with liquidation by specified tiers rather than by Capital Accounts) and has shifting or tiered distribution provisions.

Partnership agreements using target allocations (coupled with liquidation by specified tiers rather than by Capital Accounts) will fail the economic effect equivalence test when they subordinate returns of capital to preferred returns or other profit distributions to certain partners.

Draftsmen using target allocations (coupled with liquidation by specified tiers rather than by Capital Accounts) should be mindful of the possibility that they have created taxable shifts of capital between partners or unexpected loss allocations. This can occur by the preference of economic profit distributions to one partner over capital distributions to another. The tax analysis of target allocations can be considerably more complicated than most draftsmen realize.

Draftsmen using a target allocation approach (coupled with liquidation by specified tiers rather than by Capital Accounts) should consider whether their partnership agreements should contain different provisions for distributing cash from operations and cash from liquidations. The first tier distribution of cash from operations typically is a distribution of profits – often a distribution of a preferred return. The first tier distribution of cash from liquidation normally should be a return of capital rather than a payment of a preferred return. The target allocations then should reference the scheme for distributing cash from liquidation rather than the scheme for distributing cash from operations. Combining operating and liquidating distribution schemes can result in return of capital being subordinated to profits returns to some partners, can create an unintended distribution scheme, and can result in unexpected tax effects (either unexpected allocations or perhaps even income from capital shifts among partners).

A simplified allocation clause (alternative to the target allocation provision) is that: “The Partnership shall allocate its income, gain, loss, deduction, and credit in accordance with section 704 of the Internal Revenue Code of 1986, as amended.” This one sentence allocation provisions may prove perfectly satisfactory in appropriate situations.\footnote{The target allocation approach technically is designed to satisfy the economic effect equivalence test, while the “Partnership shall allocate its income, gain, loss, deduction, and credit in accordance with section 704 of the Internal Revenue Code of 1986, as amended.” This one sentence allocation provisions may prove perfectly satisfactory in appropriate situations.} The partnership could choose to say nothing about
income or loss allocations at all. This may produce results identical to the target allocation approach. These approaches are not satisfactory in all cases.

The question of whether to use a target allocation approach (coupled with liquidation by specified tiers rather than by Capital Accounts) could be considered by some advisors as principally a business matter. You put partnership economics at risk if you draft the partnership agreement so that the partnership liquidates in accordance with partners’ Capital Accounts and has traditional “layer cake” allocations. Liquidating by Capital Account in appropriate circumstances can create an economic disaster if you have fouled up the allocations or there is some unexpected nuance in allocations that you have bungled. Target allocations (coupled with liquidation by specified tiers rather than by Capital Accounts) can put nonrecourse deduction allocations at risk and can create the risk of capital shifts among partners. An intermediary approach (perhaps a clearer approach in many circumstances) is to draft express distribution provisions and express allocation provisions, but not expressly to liquidate by Capital Accounts. Another intermediary approach is to combine target allocations with liquidation by Capital Accounts. Income could be allocated to that, if the partnership distributed in accordance with the provisions for distributing operating cash, Capital Accounts would be zero at the end of the liquidation process. The partnership agreement then could distribute the proceeds of liquidation in accordance with final Capital Account balances.

It may be challenging to determine how nonrecourse deductions should be allocated when the partnership agreement uses target allocations (coupled with liquidation by specified tiers rather than by Capital Accounts). (It is especially challenging when there is not a separate provision allocating nonrecourse deductions.) Using the target allocation approach sacrifices control over the timing of allocations and the character of allocations. The target allocation approach creates particularly unsettling results if cash from operations is distributed differently from cash from liquidation. (Partner nonrecourse deductions should be allocated to the partner who bears the economic risk of loss.)

The target allocation approach (coupled with liquidation by specified tiers rather than by Capital Accounts) creates the illusion of simplicity. Tax allocations and tax consequences under the target allocation approach can be complex. Target allocations perhaps can be drafted by the village idiot (or the corporate or real estate department’s village idiot) – and too all often seem to be drafted by the village idiot (or the corporate or real estate department’s village idiot). The draftsman does not have to understand anything about how the partnership accountants will allocate gain or loss when the partnership agreement merely allocates gain or

Revenue Code of 1986, as amended” formulation relies on partners’ interests in the partnership.
loss to fill up Capital Accounts to accord with the distribution scheme. The target allocation approach invites unskilled draftsmen to draft complicated economic deals and to be oblivious to the tax consequences of the target allocations. The target allocations in effect put the partnership agreement on automatic pilot. You do not have to run projections. You do not have to have a clue how income and loss will be allocated. The client as easily could draft the allocations – or use a partnership agreement on a preprinted form or out of a form “book” – without the intervention of the corporate or real estate lawyer.

Lawyers may draft an economic scheme that results in taxable capital shifts among the partners or that can produce unexpected allocations of income to a partner that can have major impact on the partners. The partnership arrangement may result in unexpected disguised sales and other unexpected tax consequences. The standards of practice are not clear on this matter. Attorneys drafting partnership agreements using the target allocation approach may have the obligation separately to inform their clients how income and loss will be allocated under the partnership agreement. Using target allocations is not a reasonable substitute from running numbers and modeling partnership allocations. If you use target allocations, you may have greater responsibility to model allocations and to communicate to your client how they work than you would have if you used more traditionally drafted, more explicit allocations. Target allocations can create allocations substantially different from distributions of current cash flow. Consider including a tax distribution provision if you use target allocations.

The target allocation approach can invite errors by the partnership accountants. Target allocations can trade simple task for the draftsman for difficult task for the accountant. The allocations can go awry if the partnership accountants fail properly to account for minimum gain and partner nonrecourse debt minimum gain. The target allocation approach provides accountants no guidance concerning allocating nonrecourse deductions. The target allocation approach sacrifices control over allocations that you may wish to preserve.

One can imagine this real estate partnership agreement between a capital partner and a service partner. The service partner contributes $10 million in cash. The service partner contributes only services. The partnership agreement provides that cash will be distributed first to return unrecovered capital, then to pay an 8% preferred return, and finally 70% to the capital partner and 30% to the service partner. These distributions are provided for in Section y.y. Liquidating distributions follow Section y.y. The partnership agreement says nothing about allocations other than: “The net taxable income and net taxable loss for each Year of the Partnership shall be allocated to the Partners in a manner so that, at the end of the Year, the Capital Account of each Partner (adjusted appropriately for latent gain or loss that would be recognized on a sale of all assets at ‘book’ values) shall equal the amount that would have been distributed to the Partner pursuant to a
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

sale of all of the assets of the Partnership and a hypothetical liquidation under Section y.y.” Under the target allocation approach, the service partner can receive substantial allocations of taxable income, while all of the cash is being distributed to the capital partner. The target allocation approach can conceal a tax tsunami for the service provider.

Another partnership agreement for a real estate partnership would have capital contributions made by both partners. The partnership agreement distributes cash (whether from operations or in liquidation of the partnership) under Section y.y in accordance with this plan: (i) first, to Partner X until Partner X has received the return of his unrecovered capital contribution, (ii) second, to Partner X until Partner X has received an 8% return, compounded annually, on the varying balance in his unrecovered capital contribution, (iii) third, to Partner Y until Partner Y has received the return of his unrecovered capital contribution, (iv) fourth, to Partner Y until Partner Y has received an 8% return, compounded annually, on the varying balance in his unrecovered capital contribution, and (v) fifth, to Partners in accordance with Percentage Interests. The partnership agreement says nothing about allocations other than: “The net taxable income and net taxable loss for each Year of the Partnership shall be allocated to the Partners in a manner so that, at the end of the Year, the Capital Account of each Partner (adjusted appropriately for latent gain or loss that would be recognized on a sale of all assets at ‘book’ values) shall equal the amount that would have been distributed to the Partner pursuant to a sale of all of the assets of the Partnership and a hypothetical liquidation under Section y.y.” The return of Partner Y’s capital contribution is being subordinated to both the return of Partner X’s capital contribution and Partner X’s preferred return. The use of target allocations can mask the possibility that this scheme produces a capital shift or special deduction allocations to Partner Y. This distribution plan can have complicated tax effects that may not be immediately apparent if you use a target allocation scheme.

A target allocation approach (coupled with minimum gain chargeback, partner minimum gain chargeback, qualified income offset, and explicit allocations of nonrecourse deductions and partner nonrecourse debt deductions) can work satisfactorily in many situations – particularly with a partnership agreement with allocations that all conform to a single set of percentages.\(^\text{599}\)

Consider minimum gain and partner nonrecourse debt minimum gain in adjusting Capital Accounts in the hypothetical liquidation. This requires hypothetical application of the minimum gain chargeback and the partner nonrecourse debt minimum gain chargeback. A more carefully drafted target allocation approach

\(^{599}\) As discussed below, it could be questioned whether the target allocation provision works well when the partnership agreement contains a preferred return.
will provide separate paragraphs for allocations of nonrecourse deductions, partner nonrecourse deductions, minimum gain chargeback, partner minimum gain chargeback, and qualified income offset.

The target allocation approach affects character and timing of allocations to individual partners. The target allocation approach in effect charges back recourse deductions (including (without prejudice to generality) recourse depreciation deductions) with first allocations of ordinary operating income. Depreciation deductions are charged back with ordinary income. This often is contrary to what the partners want. The target allocation approach can produce odd results when a partnership has a different distribution scheme for cash from operations versus cash from liquidation.

This target allocation approach does not account satisfactorily for partner nonrecourse deductions. These partner nonrecourse deductions should be allocated to the partner whose loan funded the partner nonrecourse deductions, as the nonrecourse deduction Treasury Regulations require.

This target allocation approach does not properly meet the technical requirements of a minimum gain chargeback, a partner nonrecourse debt minimum gain chargeback, or a qualified income offset.

The target allocation approach lumps together all income and loss items into one bubbling pot and allocates them together. Partners normally consider percentage preferred returns as substitutes for interest. Interest should attract ordinary income. More traditional allocation schemes allocate ordinary operating income to the preferred return and then allocate gain from sale in the partnership’s taxable year of sale to the preferred return only if there is an insufficiency of operating income. The target allocation approach, however, will allocate a pro rata share of all partnership items (including gain from sale) to the preferred return in the partnership’s taxable year of sale (including any make-up from prior years). This is contrary to the practice that is commonly desired.

The proposed target allocation approach often will charge back prior Net Losses with Net Income as soon as the partnership has Net Income. (Some target allocation provisions operate off of gross income and gross deductions.) This Net Income often will be income from partnership operations. This usually will be ordinary income. Even when the target allocation provision operates to charge back prior depreciation deductions in the partnership’s taxable year of sale of the principal partnership assets, the paragraph will allocate a pro rata share of all year-of-sale income to charge back prior Net Losses. This can have the effect of charging back some prior recourse depreciation deductions with ordinary income from operations. Many partners will not want recourse depreciation deductions to be charged back with gain from sale rather than from income from partnership operations.
The more traditional approach with “layer cake” allocations is to wait until the property is sold before charging back prior recourse deductions – or, at least, recourse depreciation deductions. This has the advantage of deferring the charge-back until the principal asset of the partnership is sold. Then, chargeback gain often will be a combination of gain that is characterized as “unrecaptured Section 1250 gain” under Section 1(h)(6) of the Code and Section 1231 gain. This means that the partner receiving earlier recourse depreciation deductions will have those deductions charged back, often at the end of the life of the partnership, with gain that is taxed at preferential tax rates.

Another concern with the target allocation approach is how it can impact on service partners who receive profits interests for services. These partners, after a while, might well participate in a partnership liquidating distributions, but they may not receive immediate distributions. These service partners may receive substantial income allocations in years in which they receive no distributions. The common solution is to provide for tax distributions to these service partners.

Some advisors are concerned that the typical target allocation provisions do not deal satisfactorily with distributions that are made during the tax year -- distributions that may not yet have been taken into account in determining Capital Accounts. Perhaps the best answer to this objection is that the computation of Capital Accounts is dynamic, so that Capital Accounts should be adjusted as distributions are made. Draws, however, are not charged against Capital Accounts until the end of the partnership’s taxable year. Current year distributions should not normally create anomalous allocations on account of current-year’s distributions.

Perhaps the simplest allocation provision says merely:

The Net Income or Net Losses for each Fiscal Period of the Partnership shall be allocated to the Partners in accordance with their interests in the Partnership.

An alternative formulation is:

Each Partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) for each Fiscal Period of the Partnership shall be determined in accordance with the Partner’s interest in the Partnership.

The partnership agreement might say nothing about allocations of income and loss – just leave that to the partnership accountants.

600 See text accompanying note 562.
This simplest allocation provision is legally satisfactory. This provision can work completely satisfactorily for partnership agreements with all allocations and distributions based on a single set of percentage interests. This provision may meet your needs if you are inexperienced and uncomfortable with drafting allocations of income and loss.

This simplest allocation provision is unlikely to make many friends among the partnership accountants. Many accountants will not understand the guidance that this provision gives. The provision involves the simplest drafting task – if not necessarily the simplest task of interpretation.

Certain allocation provisions (for example, the minimum gain chargeback) reflect special tax concerns that are embedded in Treasury Regulations. Ensure that you understand these concepts. They will affect partners’ Capital Accounts and ultimately may affect how cash is distributed. Get help from someone who understands these concepts if you do not.

There is an intermediate position. Draft conventional allocations without providing liquidation by Capital Accounts. This should alleviate the concern about Capital Accounts being “wrong.” While the allocations in the partnership agreement will not meet the more technical test of substantial economic effect, the allocations can qualify under the economic effect equivalence test. Many draftsmen draft allocations that are designed to satisfy the economic effect equivalence test.

Ensure that you understand the difference between cash distribution provisions and tax allocation provisions. Cash is green. Cash is spendable. Taxable income is not. Walk into a Wal-Mart and try spending taxable income. The clerk will set you straight. Taxable income is not spendable. Taxable income is reportable on a partner’s tax return. Taxable losses can reduce a partner’s tax liability.

f. Curative Allocations.

Some draftsmen do not care for special allocations required by Treasury Regulations. These draftsmen may want their partnership agreements to contain a special provision that reverses these “regulatory allocations.” The purpose of curative allocations is to save the economic deal, to ensure that some unanticipat-

---

603 This refers to “curative allocations” that are used to correct distortions created by regulatory allocations. These “curative” allocations are different from “curative allocations” used to overcome the “ceiling rule” under the tax rules gov-
ed complication of regulatory allocations does not overwhelm the partnership agreement and result in capital accounts at variance with the economic scheme that the draftsman intends. This is an example of a curative allocation provision:

Section x.x Curative Allocations. The allocations set forth in Section y.y(a)(i), Section y.y(a)(ii), Section y.y(a)(iii), Section y.y(a)(iv) and Section y.y(a)(v) (collectively, the “Regulatory Allocations”) are intended to comply with requirements of the Treasury Regulations. All Regulatory Allocations (to the extent possible) shall be offset with other Regulatory Allocations or (to the extent necessary after considering expected future Regulatory Allocations) with special allocations of other items of Partnership income, gain, loss, or deduction. Notwithstanding any other provision of Article X (other than the Regulatory Allocations), the Managing Partner shall make offsetting special allocations of Partnership income, gain, loss, or deduction in whatever manner the Managing Partner determines appropriate so that (after the offsetting allocations are made) each Partner’s Capital Account balance is (to the extent possible) equal to the Capital Account the Partner would have had if the Regulatory Allocations were not terms of this Agreement and all Partnership items were allocated under Section y.y. The Managing Partner (in exercising its discretion under this Section x.x) shall take into account future Regulatory Allocations that (although not yet made) are likely to offset other Regulatory Allocations previously made. An allocation under this Section x.x (once made) shall be considered to be a Regulatory Allocation.

This is another light-weight curative allocation provision:

Section x.x Regulatory Allocations. To the extent possible, all Regulatory Allocations that may be required by applicable Treasury Regulations shall be offset by other Regulatory Allocations or special allocations of tax items so that each Partner’s share of the Net Profit, Net Loss and Capital of the Partnership will be the same as it would have been had the events requiring the Regulatory Allocations not occurred. The General Partners (based on the advice of the Partnership’s auditors or tax counsel) are authorized to make special curative allocations of tax items as may be necessary to minimize or to eliminate any economic distortions that may result from any required Regulatory Allocations. Regulatory Allocations are allocations of taxable income, gain, loss, deduction and credit (and items thereof) as may be necessary to provide that the Partnership’s allocation provisions contain a Qualified Income Offset and to governing allocations of tax items attributable to property with a “book”-tax difference (Section 704(c)(1)(A)).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

comply with all provisions relating to the allocation of so-called Non-recourse Deductions and Partner Nonrecourse Deductions and the chargeback thereof as set forth in the Treasury Regulations under Section 704(b) of the Code.

This is another example of a curative allocation provision:

Section x.x Curative Allocations. The Partners intend that the allocations set forth in this Article X shall produce final Capital Account balances of the Partners that will permit liquidating distributions that are made in accordance with Section y.y in a manner identical with how liquidating distributions would be made if they were made in accordance with Section z.z. To the extent that the allocation provisions of this Article X would fail to produce these Capital Account balances –

(a) These provisions shall be amended by the General Partner (if and to the extent necessary to produce these results) and

(b) Taxable income and taxable loss of the Partnership for prior open Fiscal Years (or items of gross income and deductions of the Partnership for prior open Fiscal Years) shall be reallocated by the General Partner to the extent that it is not possible to achieve these results with allocations of items of income (excluding gross income) and deductions for the current Fiscal Year and future Fiscal Years (as determined in the reasonable discretion of the General Partner).

This Section x.x shall control notwithstanding any reallocation or adjustment of taxable income, taxable loss, or item thereof by the Internal Revenue Service or any other taxing authority.

This is another curative allocation provision:

Section x.x Curative Allocations. The special allocations in Section y.y are intended to comply with certain requirements of the Treasury Regulations and shall be interpreted consistently therewith. The Members intend that any special allocation pursuant to Section y.y shall be offset with other special allocations pursuant to this Section x.x. Special allocations of Partnership income, gain, loss or deduction shall be made in a manner so that (in the reasonable determination of the Board, considering likely future allocations under Section y.y), after these allocations are made, each Member’s Capital Account is (to the extent possible) equal to the Capital Account it would have been were Section y.y not part of this Agreement.

The curative allocation provisions might be interpreted as saying, “if the Capital Accounts are fouled up by required allocations in Treasury Regulations, the Managing Partner shall do something – practically anything he wants – to fix them.” Save the economic deal at the cost of redoing tax allocations. Curative al-
locations are a way of admitting that regulatory allocations may create a future problem. The draftsman cannot adequately draft for that problem. The curative allocation provision gives a general partner or manager broad power to do whatever is necessary to “fix” the problem when it occurs.

These curative allocation provisions do not provide the managing partner with proper guidance on how to reallocate Partnership income, gain, loss, or deduction. These curative allocation provisions give the managing partner tremendous discretion. There is risk that the managing partner could abuse that discretion. Depending on the items of income, gain, loss, or deduction selected by the managing partner, this reallocation of partnership items could lead to litigation among the partners. Still, the curative allocation provision opts for the result that, if there is a problem, we would rather have it be a tax problem than an economic problem. The draftsman admits that he would rather have a manager do something to tinker with allocations than to risk that capital accounts might come out wrong.

Drafting an acceptable curative allocation provision requires thought and skill. Many curative allocation provisions are defective. Whether certain allocations should be offset by curative allocations is questionable. The minimum gain chargeback, for example, automatically offsets nonrecourse deductions (minimum gain). The partner nonrecourse debt minimum gain chargeback automatically offsets prior partner nonrecourse deductions. The most likely allocations that may require “cure” are qualified income offset allocations (which are rare) and allocations pursuant to a loss allocation limit. Providing a curative allocation before the operation of the minimum gain chargeback or partner nonrecourse debt minimum gain chargeback can create economic problems or can distort capital accounts. (A special case that may require some cure is a distribution of the proceeds of refinancing nonrecourse debt that can be treated as increasing nonrecourse deductions.) Curative allocation provisions should consider the potential later application of mandatory regulatory allocation provisions (for example, the minimum gain chargeback and the partner minimum gain chargeback).

Many curative allocation provisions are designed to correct regulatory allocations that automatically self-correct by themselves. Curative allocations can produce capital account distortions by seeking to reverse self-correcting allocations. The badly-drafted curative allocation provision can dangerous.

Curative allocations should be “book” allocations rather than pure tax allocations, although curative allocations provisions often fail to make this distinction. Where you use curative allocations in your partnership agreement, be careful to focus on offsetting prior allocations of “book” income or loss and not on offsetting prior allocations of taxable income or loss. Where you draft curative allocations to offset the taxable income or taxable loss that may have been allocated under regulatory allocation provisions, you may end up in a jumble on account of
the operation of the partnership tax rules governing tax allocation attributable to contributed property (Section 704(c)(1)(A)) and deemed allocations under these rules. Curative allocations put "book" capital accounts back where they would be in the absence of regulatory allocations. Curative allocations operate on "book" values (or, if properly drafted, should operate on "book" values) when a "book"-tax disparity exists.

Neither the courts nor the taxing authorities have much experience with curative allocations and the potential issues or mischief that they can create. One principal risk is that the curative allocation provision will not have been drafted properly and that it may create rather than repair capital account distortions. Another risk is that the curative allocation provision gives discretion to a manager to adjust allocations; he might do so in an unanticipated manner. Regulatory allocations might be "cured" with allocations of a character that you do not expect. Where you use a curative allocation provision, do so with considerable care. Make sure that you trust anyone who has authority to make discretionary allocations to cure prior regulatory allocations.

Curative allocation provisions are drafted with varying levels of care – or lack of care. The curative allocation provisions set forth above has questionable aspects. One curative allocation provision permits amendment of allocation provisions by the General Partner. That may be greater discretion than other members wish to give the General Partner. Some curative allocation provisions permit reallocation of taxable income and taxable loss of the Partnership for prior open years (or items of gross income and deductions of the Partnership for prior open years). This reallocation of prior years’ taxable income and taxable loss is not permitted by the partnership tax laws, subject to the limited retroactive allocation rules of Section 761.604 We do not unambiguously know how this language will be interpreted: “This Section x.x shall control notwithstanding any reallocation or adjustment of taxable income, taxable loss, or item thereof by the Internal Revenue Service or any other taxing authority.” The IRS may not consider itself bound by a curative allocation provision in the partnership agreement.

604 See I.R.C. § 761(c) (“For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

g. Tax Allocations.

Section x.x. Allocations of Tax Items. All items of income, gain, loss, and deduction for federal and state tax purposes shall be allocated in accordance with the allocation of the corresponding “book” items under this Article X (to the extent possible). In the event of a disparity between “book” value and adjusted tax basis, the tax items that correspond to “book” items shall be allocated in accordance with the principles of Section 704(c)(1)(A) (using the “traditional” method). For this purpose, “book” is used in the sense in which that term is used under Treasury Regulations Section 1.704-1(b)(2)(iv) (particularly Section 1.704-1(b)(2)(iv)(f) and (g)).

Your partnership agreement also should clarify how tax items are allocated where your partnership agreement allocates “book” items. The allocation of tax items generally should follow the allocation of the corresponding “book” items. Gain attributable to a disparity between “book” income and taxable income, will be specially allocated under the tax rules (Section 704(c)(1)(A)) that apply to contributed property with a “book”-tax disparity (particularly Treasury Regulations Section 1.704-1(b)(2)(iv)(f) and (g)). Make sure to specify a method for applying the rules of Section 704(c)(1)(A).

h. Phantom Gain.

Draftsmen often fail to understand the implications of “phantom gain” in situations in which allocations of taxable income exceed distributions of cash flow. Substantial gain may be allocated to partners. Cash will go toward repayment of partnership liabilities or payment of partner capital contributions. Partners may alter the deal to mitigate the effects of tax liability without cash flow if they understand the consequences of “phantom gain.” “Phantom gain” essentially is the amount of secured liabilities (particularly nonrecourse liabilities) in excess of the partnership’s adjusted tax basis in the security. Partners will have to pay tax on this “phantom gain.”

Separate –

- Cash distribution provisions from
- Provisions allocating taxable income and tax losses.

Do not provide simply that taxable income shall be allocated in the same manner as cash distributions. Providing that taxable income shall be allocated in the same manner in which cash is distributed can result in double return of capital contributions. Combining allocations of taxable income and cash distributions in a

---

605 See text accompanying note 644.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

single provision and allocating taxable income to follow cash distributions both are recipes for disaster.

Cash distributions include distributions returning invested cash, for which income allocations are not appropriate. A provision that merely allocates taxable income to follow cash distributions often will distort the economic deal as it allocates taxable income to partners receiving return of their capital investments. Furthermore, the timing of taxable income and cash distributions frequently will differ.

A partnership agreement for a real estate partnership often will contain a series of allocation provisions mandated by Treasury Regulations. These provisions include the minimum gain chargeback, partner nonrecourse debt minimum gain chargeback, qualified income offset, and allocation provisions for nonrecourse deductions and partner nonrecourse deductions. These provisions often apply before other allocations. Enlist aid from someone who does understand drafting these provisions if you do not understand them.

i. Nonrecourse Liabilities.

Section x.x. Allocation of Excess Nonrecourse Liabilities. All excess nonrecourse liabilities of the Partnership (as that term is used in Treasury Regulations Section 1.752-3(a)(3)) shall be allocated in accordance with Percentage Interests.

“Nonrecourse liabilities” mean liabilities for which no partner has personal liability.606 The excess of nonrecourse liabilities over the adjusted tax basis of the collateral is referred to as “minimum gain.” Clarify how nonrecourse liabilities are allocated among partners. Nonrecourse liabilities are allocated in accordance with this tiering of priorities:

- The partner’s share of partnership minimum gain.
- The amount of any taxable gain that would be allocated to the partner under the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis (or in the same manner as the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis in connection with a revaluation of

606 “A partnership liability is a recourse liability to the extent that any partner or related person bears the economic risk of loss for that liability under section 1.752-2.” Treas. Reg. § 1.752-1(a)(1). “A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under section 1.752-2.” Treas. Reg. § 1.752-1(a)(2).
partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.

- The partner’s share of the excess nonrecourse liabilities (those not allocated under the prior two tiers) of the partnership as determined in accordance with the partner’s share of partnership profits. 607

The partner’s interest in partnership profits is determined by considering all of the relevant facts and circumstances relating to the economic arrangement of the partners. Treasury Regulations permit your partnership agreement to specify the partners’ interests in partnership profits. This specification is subject to the requirement that the interests so specified are reasonably consistent with allocations (that have substantial economic effect under Treasury Regulations governing partnership allocations (Section 704(b))) of some other significant item of partnership income or gain. Your partnership agreement alternatively may allocate excess nonrecourse liabilities among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities shall be allocated. The partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Section 704(c) property (property contributed with a “book”-tax disparity) or property for which reverse Section 704(c) allocations (al-

---

607 Treas. Reg. § 1.752-3(a). A single nonrecourse liability is allocated among several properties securing the liability using any reasonable method. Treas. Reg. § 1.752-3(b)(1) (“For purposes of determining the amount of taxable gain under paragraph (a)(2) of this section, if a partnership holds multiple properties subject to a single nonrecourse liability, the partnership may allocate the liability among the multiple properties under any reasonable method. A method is not reasonable if it allocates to any item of property an amount of the liability that, when combined with any other liabilities allocated to the property, is in excess of the fair market value of the property at the time the liability is incurred. The portion of the nonrecourse liability allocated to each item of partnership property is then treated as a separate loan under paragraph (a)(2) of this section. In general, a partnership may not change the method of allocating a single nonrecourse liability under this paragraph (b) while any portion of the liability is outstanding. However, if one or more of the multiple properties subject to the liability is no longer subject to the liability, the portion of the liability allocated to that property must be reallocated among the properties still subject to the liability so that the amount of the liability allocated to any property does not exceed the fair market value of such property at the time of reallocation.”).
locations with respect to property when there have been adjustments to partnership “book” value on a permitted revaluation event) are applicable when the property is subject to the nonrecourse liability to the extent that the built-in gain exceeds the gain described in Treasury Regulations Section 1.704-2(a)(2) (the amount of any taxable gain that would be allocated to the partner under the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis (or in the same manner as the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration) with respect to the property. The partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods, to the extent that the partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner. Excess nonrecourse liabilities are not required to be allocated under the same method each year. 608

**j. Nonrecourse Deductions.**

Section x.x. Nonrecourse Deductions. Nonrecourse Deductions shall be allocated in accordance with Percentage Interests of the Partners.

“Nonrecourse deductions” are defined as the annual increase in minimum gain. 609 The annual nonrecourse deductions correspond to the annual increase in nonrecourse liabilities over the adjusted tax basis of the security for these nonrecourse liabilities (or “book” value, if there is a disparity between adjusted tax basis and “book” value). Nonrecourse deductions are “book” deductions rather than purely tax deductions.

Consider excluding nonrecourse deductions from the computation of Net Profits and Net Losses. Allocate nonrecourse deductions in a separate paragraph of partnership allocations. Nonrecourse deductions are discussed more below at note 847. Nonrecourse deductions normally are allocated under a simple scheme of percentages without tiering.

**k. Partner Nonrecourse Deductions.**

Section x.x. Partner Nonrecourse Deductions. Partner Nonrecourse Deductions shall be allocated to the Partners (as required in Section 1.704-2(i)(1) of the Treasury Regulations) in accordance with the

---

608 Id.

manner in which the Partners bear the burden of an Economic Risk of Loss corresponding to the Partner Nonrecourse Deductions.

Partner nonrecourse deductions are deductions attributable to indebtedness that is nonrecourse to the partnership but recourse to a partner on account of guarantees or because the partner is a lender. These deductions are defined in terms of the annual increase in (i) partnership nonrecourse liabilities over (ii) the adjusted tax basis (of “book” value, if the two differ) of the security.\textsuperscript{610}

I. Minimum Gain Chargeback.

These are two short formulations of the minimum gain chargeback:

\textit{Section x.x. Minimum Gain Chargeback. The “minimum gain chargeback” described in Sections 1.704-2(f) and (g) of the Treasury Regulations shall apply when there is a net decrease in the Partnership Minimum Gain during any Fiscal Year or the Partnership.}

Or this:

\textit{Section x.x Minimum Gain Chargeback. This Agreement incorporates the “minimum gain chargeback” set forth in Sections 1.704-2(f) and (g) of the Treasury Regulations (which shall apply as described in those Treasury Regulations).}

The “minimum gain chargeback” allocates the income corresponding to the minimum gain to the partners who received prior allocations of nonrecourse deductions (or the cumulative minimum gain) when minimum gain is reduced.\textsuperscript{611} It is the highest-priority allocation that occurs before any other allocation under your partnership agreement. It is an allocation of “book” income to partners who received prior allocations of nonrecourse deductions.\textsuperscript{612} (The minimum gain chargeback is a “book” concept and not purely a tax concept.) The minimum gain chargeback allocation reverses these prior allocations of nonrecourse deductions. It technically allocates item of gross income (gross “book” income). The minimum gain chargeback is the first to apply of a series of “regulatory allocations.”

\textsuperscript{610} See Treas. Reg. § 1.704-2(j)(1)(ii) (“Partnership losses, deductions, and Section 705(a)(2)(B) expenditures are treated as partnership nonrecourse deductions in the amount determined under paragraph (c) of this section (determining nonrecourse deductions) in this order: (A) First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities; (B) Then, if necessary, a pro rata portion of the partnership’s other deductions, losses, and Section 705(a)(2)(B) items.”).

\textsuperscript{611} Treas. Reg. § 1.704-2(f).

\textsuperscript{612} See discussion of “book” items in text accompanying note 9.
The partner nonrecourse debt minimum gain chargeback often applies second. The qualified income offset applies third. Your partnership agreement should contain an ordering provision clarifying the order of application of these provisions.

Consider the minimum gain chargeback in designing other allocation provisions. Some allocation provisions are designed to set capital accounts to target levels. Remember, in drafting these provisions, that the minimum gain chargeback will apply later automatically. Adjust Adjusted Capital Accounts rather than true capital accounts to target levels. Adjusted Capital Accounts are capital accounts increased by the partner’s share of minimum gain (or potential allocation under the minimum gain chargeback) and the partner’s share of partner nonrecourse debt minimum gain (or potential allocation under the partner nonrecourse debt minimum gain chargeback).

The minimum gain chargeback preferentially allocates gain from the disposition of the security for the nonrecourse liabilities. There may be a deficiency. Then, the minimum gain chargeback sweeps the partnership’s other income and gain items (generally excluding gain from reduction in partner nonrecourse debt minimum gain on the disposition of property securing partner nonrecourse debt).

m. Partner Nonrecourse Debt Minimum Gain Chargeback.

“Partner nonrecourse liabilities” are nonrecourse liabilities when a partner bears the economic risk of loss of the liabilities. Partner nonrecourse deductions

---

613 Which gain items are allocated under the minimum gain chargeback? Treasury Regulations provide:

(i) Minimum Gain Chargeback. Items of partnership income and gain equal to the minimum gain chargeback requirement (determined under paragraph (f) of this section) are allocated as a minimum gain chargeback in this order:

(A) First, gain from the disposition of property subject to partnership nonrecourse liabilities;

(B) Then, if necessary, a pro rata portion of the partnership’s other items of income and gain for that year. Gain from the disposition of property subject to partner nonrecourse debt is allocated to satisfy a minimum gain chargeback requirement for partnership nonrecourse debt only to the extent not allocated under [the partner nonrecourse debt minimum gain chargeback].


614 More precisely: “‘Partner nonrecourse debt’ or ‘partner nonrecourse liability’ means any partnership liability to the extent the liability is nonrecourse for purposes of section 1.1001-2, and a partner or related person (within the meaning (footnote continued on the next page)
correspond to nonrecourse deductions. Partner nonrecourse deductions apply to partner nonrecourse debt. The “partner nonrecourse debt minimum gain chargeback” similarly applies to reductions in partner nonrecourse debt minimum gain. The partner nonrecourse debt minimum gain chargeback allocates income (“book” income) to the partners previously allocated partner nonrecourse deductions in situations in which partner nonrecourse debt minimum gain is reduced (for example, on the sale of the collateral). The partner nonrecourse debt minimum gain chargeback technically allocates items of gross “book” income.\footnote{See discussion of “book” items in text accompanying note 9.}

These are two short formulations of the partner nonrecourse debt minimum gain chargeback:

Section x.x. Partner Nonrecourse Debt Minimum Gain Chargeback. The “partner nonrecourse debt minimum gain chargeback” (described in Section 1.704-2(i)(4) of the Treasury Regulations) shall apply if there is a net decrease in Partner Nonrecourse Debt Minimum Gain (during any Fiscal Year).

Or this:

Section x.x. Partner Nonrecourse Debt Minimum Gain Chargeback. This Agreement incorporates the “partner nonrecourse debt minimum gain chargeback” set forth in Sections 1.704-2(i)(4) of the Treasury Regulations.

n. Exculpatory Liability Minimum Gain Chargeback.

Section z.z. Exculpatory Liability Minimum Gain Chargeback. If there is a net decrease in Exculpatory Liability Minimum Gain of the Company for a Company Taxable Year, the Exculpatory Liability minimum gain chargeback requirement of this Section z.z shall apply. The Exculpatory Liability minimum gain chargeback shall require a chargeback of income and gain determined in accordance with the principles of Treasury Regulations Section 1.702-2 (and most particularly paragraphs (d), (f), (g) and (h) of this regulation), computed by considering only Exculpatory Liabilities as “nonrecourse liabilities” and computed as if Exculpatory Liabilities were “nonrecourse liabilities” of the Company encumbering all assets of the Company that may be reached by a creditor of the Company with respect to these Exculpatory Liabilities.

of section 1.752-4(b)) bears the economic risk of loss under section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.” Treas. Reg. § 1.704-2(b)(4).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

This provision corresponds to the Nonrecourse Deduction Minimum Gain Chargeback; however, it applies to charge backs of Exculpatory Deductions. Exculpatory liabilities are discussed in more detail in the text accompanying note 900.

0. Qualified Income Offset.

The qualified income offset is a picky tax allocation provision that rarely applies and that practically defies explanation. The qualified income offset normally should be included in a real estate partnership agreement. This is explained further in the text at note 1040 and note 1063 below. The qualified income offset allocates items of “book” income.

These are two simple formulations of the qualified income offset:

Section x.x Qualified Income Offset. Any Partner who unexpectedly receives an adjustment, allocation or distribution described in subparagraphs (4), (5) or (6) of Section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations (which adjustment, allocation or distribution creates or increases a deficit balance in that Partner’s Capital Account), shall be allocated items of “book” income and gain in accordance with the provisions of the “qualified income offset” as described in Section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations.

Or this:

Section x.x Qualified Income Offset. This Agreement incorporates the “qualified income offset” set forth in Sections 1.704-1(d) of the Treasury Regulations as if its provision were fully set forth in this Agreement.

This is another example of a qualified income offset (not a particularly good example) that does not depend so heavily on the cross-reference to Treasury Regulations:

Section x.x Qualified Income Offset. The Partnership shall allocate items of Partnership income and gain (in accordance with Treasury Regulations Section 1.704-1(b)(2)(ii)(d)), to any Member who unexpectedly receives an adjustment, allocation or distribution described in Treasury Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5) or (6). This allocation shall be made in an amount and manner sufficient to eliminate (to the extent required by the Treasury Regulations) the Adjusted Capital Account Deficit of the Member as quickly as possible. An allocation under this Section x.x shall be made if and only to the extent that the Member would

have an Adjusted Capital Account Deficit after all other allocations described in this Article X have been tentatively made as if this Section x.x were not in the Agreement. This Section x.x is intended to qualify and to be construed as a “qualified income offset” (within the meaning of Treasury Regulations Section 1.704-1(b)(2)(ii)(d)) and shall be interpreted consistently therewith.

You could compactly consolidate the minimum gain chargeback, the partner nonrecourse debt minimum gain chargeback and the qualified income offset into one paragraph:

Section x.x Regulatory Allocations. This Agreement incorporates the “minimum gain chargeback” set forth in Sections 1.704-2(f) and (g) of the Treasury Regulations, the “partner nonrecourse debt minimum gain chargeback” set forth in Sections 1.704-2(i)(4) of the Treasury Regulations, and the “qualified income offset” set forth in Sections 1.704-1(d) of the Treasury Regulations, as if those provisions were fully set forth in this Agreement.

These “regulatory allocations” are highest priority allocations. Treasury Regulations provide: “For purposes of this section, the following ordering rules apply to partnership items. Notwithstanding any other provision in this section and section 1.704-1 allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.” 618

Partnership allocations, beyond these special “regulatory allocations,” will reflect the underlying economics of the partnership. Allocations of net income and net losses will be reflected in partnership capital accounts. A partner should receive the amount in his capital account upon termination of the partnership, regardless of whether the partnership explicitly distributes the proceeds of liquidation in accordance with partnership capital accounts.

p. Chargebacks.

Real estate partnerships often have early year net losses, followed by net profits. Your partnership agreement often will contain a “chargeback” provision that allocates net profits in effect to reverse the economic effects of prior loss allocations. These chargebacks are allocations of “book” income, often Net Profits or perhaps gain from sale of capital assets. 619 Often, this chargeback will parallel prior loss associations on a tier-by-tier basis. Alternatively, net profits may first

---

chargeback negative capital accounts and then build up positive capital accounts on a tier-by-tier basis to conform to the economic deal. These chargeback provisions may allocate income from partnership operations or may merely allocate gain from sale of partnership property. Coordinate chargeback provisions with the minimum gain chargeback and the partner nonrecourse debt minimum gain chargeback so that there is not a double chargeback of prior partnership losses. Do not charge back prior nonrecourse losses with an allocation of partnership net profits. Charge back prior nonrecourse losses only with an income allocation under the minimum gain chargeback. Charge back prior partner nonrecourse deductions only with an income allocation under the partner nonrecourse debt minimum gain chargeback. Many partnership agreements are troubled with chargebacks of prior nonrecourse deductions through the normal gain chargeback provision and then will result in a second chargeback under the minimum gain chargeback.

q. Preferred Return.

Drafting income allocations corresponding to a preferred return often requires allocating income that parallels the accrual (rather than the distribution) of the preferred return. The allocation corresponding to the preferred return may be an allocation of Net Profits or perhaps gain from sale of capital assets. This is an allocation of “book” income. An allocation might read: “While the cumulative allocation to Partner X under this Section x.x is less than the amount of the Partner X Preferred Return, Net Profits shall be allocated exclusively to Partner X.” In defining the “Partner X Preferred Return,” clearly define its various computational elements: interest rate, frequency of compounding, date of compounding, computational year, base against which the return is computed, increases and reductions to the base, when contributions are made, when distributions are made, etc. Preferred returns are discussed further in the text accompanying note 544.

r. Internal Rate of Return.

Leave drafting income allocations corresponding to an internal rate of return to an expert draftsman. These provisions are difficult to draft. (A simplifi-

---

621 See discussion of cash distributions based on internal rate of return in text as note 547. Annual differences between net income and cash distributions create the problem. Income allocations can precede cash distributions. You do not know how much cash will be distributed under a tier providing for distributions until a partner achieves a specified internal rate of return. This makes it difficult to know how much income to allocate corresponding to the tier providing for a distribution necessary to achieve a prescribed internal rate of return. You may allocate too much income under the income tier corresponding to the internal rate of return (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

dified approach is to use target allocations.) Merely providing income allocations for preferred returns and returns based on internal rate of return that allocate taxable income to a partner until he has been paid the required return normally will produce unsatisfactory economic results. Indeed, this could produce economically disastrous results. The problem with drafting Net Profits tiers based on internal rate of return is that we may not know how much in the way of economic profits should be allocated to the internal rate of return tier until the partnership sells its basic assets. We may not know in an early year whether a distribution should be characterized as a return of capital, a capital shift, or a distribution of economic profits. Net Profit allocations in internal rate of return deals generally involve drafting compromises.

The income allocation might provide a tier something like:

First, the Partnership shall allocate Net Profits for each Fiscal Year exclusively to Partner X under this Section x.x in a manner so that (after the allocation of Net Profits) Partner X has (to the extent possible) an Adjusted Capital Account so that,

(i) if the Adjusted Capital Account were distributed to Partner X in liquidation of the Partnership on the date of the allocation,

(ii) Partner X would have received aggregate cumulative distributions of Available Cash and Proceeds of Liquidation sufficient so that the Internal Rate of Return to Partner X from the formation of the Partnership shall be no less than the Specified IRR (for this purpose considering only the lowest positive real Internal Rate of Return to Partner X).

In this context,

“Adjusted Capital Account” means the Partner’s Capital Account, increased by the Partner’s share of minimum gain and increased further by the Partner’s share of Partner Nonrecourse Debt Minimum Gain and anticipated allocations to the Partner under the Qualified Income Offset.

Adjusted Capital Accounts are useful in drafting many partnership allocations. Adjusted Capital Account signifies the partner’s capital account increased by income that will be recognized under the minimum gain chargeback and the partner nonrecourse debt minimum gain chargeback and potential income allocations to the partner under the qualified income offset. Using “Capital Account”

distribution tier if you allocate income under this tier until a partner receives cash distributions giving the partner the specified internal rate of return. Allocations should be drafted so that they are indifferent to the ordering of income or loss, capital contributions or cash flow.
rather than “Adjusted Capital Account” in the allocation set forth above can produce idiosyncratic results (which are often incorrect) in the formula set forth above.

Another technique for allocating Net Profits and Net Losses is to base the allocations on whatever set of allocations would permit the partnership to liquidate in accordance with capital accounts and to distribute cash in liquidation in accordance with the required cash distribution scheme. This is an example:

Section x.x Allocation of Net Profits and Net Losses. The Partnership shall allocate Net Income or Net Losses for each Fiscal Period of the Partnership to the Partners in a manner Sunshine Partners that (at the end of the Fiscal Period) the Capital Account of each Partner (as adjusted under this Section x.x) shall equal the amount that would have been distributed to the Partner pursuant to a hypothetical liquidation under Section y.y. For this purpose, a hypothetical liquidation means the sale of all of the assets of the Partnership in a taxable disposition for the “book” value of these assets (or, if greater, the amount of nonrecourse liabilities secured by these assets), the debts of the Partnership are paid, and the remaining amounts are distributed to the Partners in liquidation under Section y.y. For this purpose, each Partner’s Capital Account shall be hypothetically adjusted as if the sale has occurred during the Fiscal Period.

The hypothetical liquidation described in this paragraph adjusts Capital Accounts for both minimum gain and partnership minimum gain and corrects the formula.

Both of these provisions, however, have limitations. Distributions to a partner in an early year beyond his invested capital and Net Profits allocated to the partner in that year may result in a shift of capital between partners.

Other Net Profit allocation provisions concerning internal rate of return tiers may provide greater control over character and timing – or amount; however, these provisions require drafting skill and often require economic assumptions that will affect the allocations. Some agreements will allocate all Net Profits to a partner until the partner has satisfied the internal rate of return distribution test. This can distort the economic deal. Some agreements will allocate gross income rather than net income to a partner receiving a distribution under an internal rate of return tier in order to avoid a capital shift.

You are discouraged from simply using this naïve formulation:

Section x.x Allocation of Net Profits and Net Losses. The Partnership shall allocate Net Income or Net Losses for each Fiscal Period of the Partnership to Partner X until Partner X has received Distributions sufficient to give Partner X a 10% internal rate of return on his Net Invested Capital.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

This paragraph (commonly found in partnership agreements) can produce bizarre results. The partnership may have substantial Net Profits and substantial cash flow (more than enough to give Partner a 10% internal rate of return on Net Invested Capital). Distributions may be blocked by lender requirements or cash may be reinvested by the partnership in capital assets. This clause can cause the capital account of Partner X to build up (on account of Profits allocations) far beyond what is necessary to give Partner X a 10% internal rate of return. The allocation of all Net Losses to Partner X while Partner X has not yet received distributions sufficient to give Partner X a specified internal rate of return may make no sense at all.

Drafting acceptable allocations of Net Profits for a deal based on internal rates of return is greatly aided by sound projections.

s. Tracking and Schedular Allocations.

Some partnership allocations provide for tracking or schedular allocations – allocations that track particular assets and specially allocate the results of particular partnership assets or bundles of assets in a particular way. These allocations are similar to ABC stock (or tracking stock) that is issued by many corporations. One example of a partnership that particularly lends itself to tracking or schedular allocations is the series limited liability company. Partnership case law, statutory law and administrative law have not yet directly addressed the tax effects of partnership tracking allocations. There is little doubt that certain special allocations of partnership items are permitted. Special allocations perhaps can result in a single state law partnership being treated as more than one tax partnership in appropriate circumstances – or perhaps as the partnership having distribut ed property to a partner or interests in a subsidiary partnership to some partners. Partnership case law, statutory law and administrative law have not established an accepted analysis of when a single partnership can be treated as multiple tax partnerships on account of tracking of schedular allocations. We can speculate that having different partners on different schedules, having low percentage points of common interest across different schedules and having liability partitions between different classes of assets might be considered by a court in making this determination. Concern about a single nominal partnership being treated as multiple partnerships should be enhanced whenever schedular allocations are coupled with a structure that limits cross-liability of different classes of partnership assets – for example, through the use of series entities or a single partnership with several single member limited liability companies as subsidiaries.

622 See discussion in text accompanying note 731.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Revenue Ruling 55-39\(^{623}\) may bear on tracking or schedular allocations. This ruling considers an extreme case of tracking or schedular allocations. This morsel is easily devoured in one bite without satisfying our appetite for clarifying authority.

The taxpayer in Revenue Ruling 55-39 was a general partner of a limited partnership. The limited partners were entitled to a fixed return on their respective capital contributions plus an additional contingent return, dependent upon net earnings. The general partners were entitled to “interest” at the rate of six percent on their respective capital accounts; thereafter, the general partners shared all gains and losses in specified but varying percentages. Some of the general partners received salaries. All general partners were permitted to make certain withdrawals (including withdrawals for the purpose of paying Federal and State income taxes on their respective shares of the firm’s profits). The partnership agreement (or perhaps an amendment to the partnership agreement) provided that the taxpayer could direct that the sum constituting his capital account be invested (in whole or in part) in securities of his selection. This investment direction may be a critical aspect leading to the holding. The taxpayer had control over management of the account. The purchase price of the securities was charged to his capital account if he exercised this power. This reduced the preferred return on his capital account. (It does not appear that this charge reduced the amount that the taxpayer would receive in liquidation of the partnership.) The taxpayer’s capital account then would be credited with any dividends, interest or other distributions received by the partnership with respect to the securities that were purchased on his behalf – as if the taxpayer owned the securities. The increase or decrease in the value of the securities would be for the taxpayer’s account – as if the taxpayer directly owned the securities. The taxpayer apparently retained power to sell the securities at his request. This perhaps is critical to the holding – and perhaps is not. The proceeds of sale in that event would be credited to his capital account – as if the taxpayer owned the securities. The partnership agreement provided that the securities so purchased “shall become and remain the property of the partnership and shall be deemed part of the capital” contributed by the taxpayer. The partnership agreement provided that the taxable income accruing to the taxpayer upon the securities segregated for the partner’s behalf, or by reason of the sale of these securities “shall be deemed taxable income from the firm, or net capital gain from the firm” for purposes of ascertaining withdrawals permitted to the taxpayer for payment of Federal and State income taxes. Upon becoming entitled to a distribution of capital or to withdraw capital, upon termination of the partnership or upon retirement or otherwise, taxpayer or his estate was entitled to receive “any securities in his capital account” in kind. This might be a critical aspect of the rul-

\(^{623}\) 1955-1 C.B. 403.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

ing – or it might not be. The taxpayer had the right to withdraw the securities. All economic aspects of the securities accrued to the taxpayer for most purposes. The partnership agreement, however, provided that securities purchased by the partnership for the taxpayer’s account “shall become and remain the property of the partnership and shall be deemed part of the capital” contributed by the taxpayer. The securities would be treated as partnership property as respects the claims of creditors.

The ruling considered the securities the property to the taxpayer and not of the partnership:

Subjection of properties, other than partnership assets, to the claims of firm creditors is so commonly attained by specific agreement, by guaranty, by pledge, or by representations, that such subjection, as evidencing intent to convert property into partnership property, may be rebutted by provisions inconsistent with such intent. Where, as here, the agreement provides that certain property is acquired and held for the account of a particular partner, and all of the incidents of ownership, including the right to be credited with all income and profits therefrom and all rights of control, are in him, such property cannot qualify as jointly owned property.

In view of the foregoing, it is held that the securities become the property of the taxpayer at the time they are acquired for him by the partnership. When the partnership acquires the securities for the taxpayer, it in effect distributes cash to him in the amount of the cost of the securities purchased. A subsequent distribution of the securities to him is not a distribution of partnership property and has no Federal income tax consequences. Accordingly, for the purposes of determining basis and computing holding period, the taxpayer acquires the securities at the time they are purchased for his account, and at a cost equal to the purchase price.

Since the partnership agreement permits withdrawal of contributed capital without diminution of the taxpayer’s participation rights in gains or losses, it is further held that withdrawals of contributed capital under the agreement are not in payment for or liquidation of part of his interest in the partnership. Accordingly, an investment of his contributed capital in securities of his own choice, and for his own account, is in effect a withdrawal of such capital from the firm and an investment by him in the securities purchased, resulting in a reduction in the basis of his partnership interest.

Revenue Ruling 55-39 clarifies that it is possible for partnership property under certain conditions to be treated as property distributed to a partner. This ruling has not been cited in other published authority, so its sweep is difficult to
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING 
PARTNERSHIP AND LLC AGREEMENTS AND 
SOME BASIC ISSUES IN 
DRAFTING REAL ESTATE 
PARTNERSHIP AND LLC AGREEMENTS

gauge. Special allocations of all of the income and loss from a class of assets to a subset of partners perhaps could be treated as a division of the partnership into two partnerships, but there is no case law exploring this possibility. The case for a division could be enhanced if that subset of partners has management and control over the asset pool that is the subject of the special allocation. The case for a partnership division is enhanced if the asset pool is held in a series or a liability limiting entity that protects other partnership assets from liabilities of the asset pool. The case for a partnership division is enhanced if the asset pool is protected from partnership liabilities related to other partnership assets if these other partnership assets are similarly held in a liability limiting entity. The case for a partnership division may be particularly strong if there is a substantial lack of overlap of economic interests between the economics of the asset pool and the economics of other partnership assets. There is no commonly-accepted analytical structure for determining when special allocations can result in the deemed distribution of an asset to a partner or a deemed division of the partnership into two or more partnerships. It is possible that merely holding assets through one state law partnership entity is enough for the venture to be treated as a single tax partnership. The law considering deemed distributions and deemed partnership divisions is immature.624

624 Revenue Ruling 55-39 has spawned ILM 200650014 (September 7, 2006). That ILM concludes that: “The non-recognition provision of § 731 and substituted basis rule of § 732(b) do not apply when a partnership acquires residential real estate that has no relation to a partnership’s business activities, solely for purposes of immediately distributing the real estate to a partner in liquidation.” Partnership owned a large parcel in State X. Due to ongoing disagreements among the partners, the exiting partners, including Taxpayer, liquidated their interests in Partnership leaving the remaining partners in control of Partnership. Taxpayer’s partnership interest was specifically outlined in a redemption agreement. The redemption agreement provided for the purchase and distribution in redemption to Taxpayer of a house in State Y. Specifically, the redemption agreement provided: “To transfer the State Y house to Taxpayer, the following occurred. First, Partnership formed an LLC. Next, on Date 1, Year 1, the LLC purchased the State Y house for $c. The consideration that LLC used to purchase the State Y house consisted of $d cash loaned by B, a partner who was also to be redeemed under the redemption agreement, and $j cash of LLC or Partnership. Pursuant to the terms of the redemption agreement, in Date 2 of Year 2, Taxpayer took out a $e mortgage against the State Y house and used the proceeds to pay LLC. LLC then repaid B. Simultaneously, LLC transferred the State Y house to Taxpayer by grant deed.” The ILM reasoned:

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Under the facts presented in this case, a carry-over basis is not appropriate for a unique parcel of residential property that apparently was selected by the distributee, acquired by the partnership immediately before the distribution, solely for the purpose of the distribution, and was unrelated to the partnership’s business activities.

Moreover, the facts are consistent with a finding that Partnership was never the owner of the State Y house for federal tax purposes. A significant portion of the purchase price for the State Y house was provided by funds borrowed from Taxpayer’s relative (relative), a loan that was immediately repaid by Taxpayer. The redemption agreement provided that, if Taxpayer did not pay all of the expenses associated with the transaction and repay Partnership the amount of the purchase price in excess of $a within a stated period of time, the State Y house would be sold, Partnership reimbursed for expenses and provided an amount in liquidated damages, the relative lender repaid, and the remaining funds distributed to Taxpayer.

The facts in this case are consistent with a finding that the State Y house was acquired and held for the account of Taxpayer and became property of the Taxpayer at the time it was acquired for Taxpayer by the Partnership. See Rev. Rul. 55-39, 1955-1 C.B. 403 (investment by partnership of partner’s contributed capital in securities of partner’s choice and for partner’s own account constituted a withdrawal of capital from the partnership and an investment by partner in securities purchased, resulting in reduction in partner’s partnership interest). When Partnership purchased the State Y house for Taxpayer, it in effect distributed cash to Taxpayer in the amount of the $a, the amount used by Partnership to acquire the State Y house. The subsequent purported distribution of the State Y house to Partner is not a distribution of partnership property under § 731. See id.

The ILM also applies the anti-abuse rules of Treas. Reg. § 1.701-2 and the step transaction and economic substance doctrines. See, for example, Andantech LLC v. Commissioner, T.C. Memo. 202-07, aff’d in part and remanded in part, 331 F.3d 975 (D.C. Cir. 2003); True v. United States, 190 F.3d 1165, 1176-77 (10th Cir. 1999); Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210, 213-214 (D.C. Cir. 2001), cert. denied, 534 U.S. 1104 (2002); Smith v. Commissioner, 78 T.C. 350, 389 (1982), aff’d without opinion, 820 F.3d 1220 (4th Cir. 1987); Associated Wholesale Grocers, Inc. v. Commissioner, 927 F.2d 1517 (10th Cir. 1991); Gregory v. Helvering, 293 U.S. 465 (1935); United States v. Wexler, 31 F.3d 117, 122, 124 (3d Cir. 1994); Yoshia v. Commissioner, 861 F.2d 494, 498-99 (7th Cir. 1988), aff’d Glass v. Commissioner, 87 T.C. 1087 (1986); Goldstein v. Commissioner, 364 F.2d 734 (2d Cir. 1966), aff’d 44 T.C. 284 (1965); ACM (footnote continued on the next page)
Revenue Ruling 55-39 suggests the use of schedular allocations as an affirmative tool to treat partnership assets as assets that have been distributed to a partner. The partnership may have a loan structure that does not permit the partnership to move the ownership of an asset. An asset, for example, may be isolated in a single member limited liability company as a bankruptcy remote entity. The partnership may desire to undertake a transaction that will be treated as a distribution of the property for federal income tax purposes. The partnership agreement might be amended to provide for these terms:

- The asset subject to the schedular special allocation is identified as a Schedule A Asset.
- All income and loss from the Schedule A Asset will be allocated exclusively to a single partner.
- The partner is the sole person who receives the economic benefits from, and bears the risk of loss of, the Schedule A Asset.
- All proceeds of the Schedule A Asset become a Schedule A Asset.
- The Schedule A Asset does not bear any of the economic risk of loss of other assets.
- The amount of allocation that the partner receives from the Schedule A Asset does not in any way affect the partner’s participation in the economics of other partnership allocations.
- The partner is entitled, at his option, to withdraw any of the assets comprising the Schedule A Asset, subject to compliance with lender restrictions. These withdrawals will affect the partner’s participation in the Schedule A Asset, but will not affect the partner’s participation in the other economic aspects of the partnership.
- The partner can direct the investment or reinvestment of Schedule A Asset.
- The partner can direct the sale of Schedule A Asset without the approval of the other partners.

---

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- The partner has complete management control over the Schedule A Asset.
- The partner is entitled to receive the Schedule A Asset on liquidation of the partnership.
- As a practical economic matter, the Schedule A Asset is not subject to the general liabilities of the partnership assets.

This arrangement might be useful if the partnership planned to undertake a “drop and swap” arrangement in which the partnership distributed an asset to the partner prior to sale of the asset. The partner completes sale of the asset as a like-kind exchange. The limits of this schedular allocation methodology are yet to have been tested. For example, it is not clear that this methodology could be used for isolating tenancy in common interests in an asset in separate single member limited liability companies, each owned by the partnership, and having the partnership make schedular allocations with respect to each of these single member limited liability companies to a separate partner. There is substantial room for doubt that the principles of Revenue Ruling 55-39 would apply to this arrangement. Similarly, it is not clear how Revenue Ruling 55-39 will apply when schedular allocations are made to a subset of the partners. This conceivably could be treated as a distribution of a partnership interest to these partners, or it could be treated as nothing more than special allocations. The tax law still must come to grips with the analysis of schedular allocations.

Recapture Amounts.

Recapture Items. Each Partner’s distributive share of taxable gain or loss from the sale of Partnership assets (to the extent possible) shall include a share of the recapture income as required by applicable law (to the extent that the Partnership has taxable income that is characterized as ordinary income under the recapture provisions of the Code). Subject to the foregoing,

(a) Each Partner who has received (or whose predecessor in interest has received) a prior share of the items subject to recapture shall be allocated a share of recapture income proportionate to that Partner’s share (including its predecessor in interest’s share) of prior cumulative depreciation deductions with respect to the assets that created the recapture income (but not in excess of the Partner’s share of gain from the disposition of the asset creating recapture income).

(b) Any excess depreciation recapture shall be allocated among the Partners in accordance with the ratio of their allocations of gain or recapture from the disposition of the property giving rise to the depreciation recapture.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(c) If the Partnership has taxable income that is characterized
as “unrecaptured Section 1250 gain” under Section 1(h) of the Code,
each Partner’s distributive share of the gain shall be equal (to the extent
possible) to the amount of Section 1250 capital gain that would be allo-
cated (taking into account any remedial allocation under Treasury Regu-
lations Section 1.704-3(d)) to that Partner if Section 1250(b)(1) included
all depreciation and the applicable percentage under Section 1250(a)
were 100 percent.

Allocations of depreciation deductions in early years typically will result
in recapture of past depreciation as ordinary income in later years when the
depreciable property is disposed of. Partnership property is subject to essentially the
same depreciation recapture rules to which other taxpayers are subject. Deprecia-
tion recapture income must be allocated among the partners. Recapture can be by
way of ordinary income under provisions like Section 1245 (depreciation recap-
ture with respect to personal property) or Section 1250 (depreciation recapture
with respect to real property) or income taxed at a 25% rate under Section 1(h) in
the case of unrecaptured Section 1250 gain (depreciable real property).625 Special
depreciation recapture rules apply where special basis adjustments (Section 743
adjustments) have resulted from basis adjustment elections (Section 754 elec-
tions) and where property has been contributed by a partner with a “book”-tax
disparity (Section 704(c)).

Treasury Regulations illustrate the basic partnership depreciation recap-
ture rules under Section 1245 with this example.

625 I.R.C. § 1(h)(6) provides:

(6) Unrecaptured section 1250 gain. For purposes of this subsection—

(A) In general. The term “unrecaptured section 1250 gain” means the
excess (if any) of—

(i) the amount of long-term capital gain (not otherwise
treated as ordinary income) which would be treated as ordinary income if
section 1250(b)(1) included all depreciation and the applicable percen-
tage under section 1250(a) were 100 percent, over

(ii) the excess (if any) of—

(I) the amount described in paragraph (4)(B);

over

(II) the amount described in paragraph (4)(A).

(B) Limitation with respect to section 1231 property. The amount de-
scribed in subparagraph (A)(i) from sales, exchanges, and conversions
described in section 1231(a)(3)(A) for any taxable year shall not exceed
the net section 1231 gain (as defined in section 1231(c)(3)) for such year.
Example. A partnership sells for $63 section 1245 property which has an adjusted basis to the partnership of $30 and a recomputed basis to the partnership of $60. The partnership recognizes under section 1245(a)(1) gain of $30, i.e., the lower of the amount realized ($63) or recomputed basis ($60), minus adjusted basis ($30). This result would not be changed if one or more partners had, in respect of the property, a special basis adjustment described in section 743(b) or had taken depreciation deductions in respect of such special basis adjustment.626

Extensive Treasury Regulations control how depreciation recapture is allocated among partners. Section 1245 depreciation recapture and Section 1250 recapture are allocated to the partners who received prior depreciation deductions in proportion to their shares of prior recapture, limited to their shares of the gain. Each partner’s distributive share of Section 1245 recapture equals the lesser of:

- The partner’s distributive share of gain from the disposition of the property subject to recapture, or
- The partner’s cumulative share of depreciation or amortization with respect to the property.627

You need not list all of the rules for allocating depreciation recapture. Treasury Regulations on depreciation recapture apply automatically.

There may be excess depreciation recapture income after application of this rule. The remaining excess depreciation recapture income is allocated among those partners –

- Whose shares of total gain from the disposition of the depreciation recapture latent property exceed
- Their shares of the depreciation recapture income from the disposition of the property.

The allocation of excess depreciation recapture is made among these partners in accordance with the ratio of their shares of the total gain (including recapture income) from the disposition of the depreciation recapture latent property. In no event, however, is a partner allocated greater depreciation recapture than his share of the total gain (including depreciation recapture income) from the disposition of the property subject to depreciation recapture. A partner’s share of depreciation or amortization with respect to depreciation recapture latent property

---

626 Treas. Reg. § 1.1245-1(e)(1).
equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.\textsuperscript{628}

The Section 1245 depreciation recapture rules for partnerships apply to property acquired by a partnership on or after August 20, 1997. Generally, a partner’s share of recapture income with respect to a property equals the total amount of depreciation or amortization with respect to the property previously allocated to that partner. The Section 1245 Treasury Regulations prescribe substantial additional rules (illustrated with examples) that consider depreciation recapture with respect to contributed property and property with Section 743 adjustments.\textsuperscript{629}

Treasury Regulations prescribe these partnership Section 1245 depreciation recapture rules:

\begin{itemize}
  \item A partner’s share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.\textsuperscript{630}
  \item If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner.\textsuperscript{631}
  \item If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.\textsuperscript{632}
  \item A partner’s share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed.\textsuperscript{633}
  \item A partner’s share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any curative allocations under the rules for property contributed with a “book”-tax disparity (Section 704(c)).
  \item The contributing partner’s share of depreciation or amortization with respect to the contributed property is decreased (but not be-
\end{itemize}

\textsuperscript{628} Treas. Reg. § 1.1245-1(e)(2)(ii)(A).
\textsuperscript{629} Treas. Reg. § 1.1245-1(e)(2)(ii), (3).
\textsuperscript{630} Treas. Reg. § 1.1245-1(e)(2)(A).
\textsuperscript{631} Treas. Reg. § 1.1245-1(e)(2)(B).
\textsuperscript{632} Treas. Reg. § 1.1245-1(e)(2)(C)(1).
\textsuperscript{633} Treas. Reg. § 1.1245-1(e)(2)(C)(2).
low zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to that contributed property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partners with respect to that contributed property. 634

- A noncontributing partner’s share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner’s share of any curative allocation of ordinary income to the contributing partner with respect to that contributed property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. 635

- The partners’ shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken, are determined without regard to those curative allocations. 636

- A partner’s share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. 637

- The contributing partner’s share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. 638

- A noncontributing partner’s share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. 639

Partnership recapture rules under Section 1250 are parallel to the Section 1245 recapture rules. A partnership may dispose of section 1250 property. The amount of gain recognized under Section 1250(a) by the partnership and by a

634 Id.
635 Id.
636 Id.
638 Id.
639 Id.
partner is determined in a manner consistent with the principles described in the Section 1245 recapture rules (Treasury Regulations Section 1.1245-1(e)).

u. Special Allocation of Imputed Interest.

Section x.x. Imputed Interest. Interest income recognized under Section 483 or Sections 1271 through 1288 of the Code in connection with any Partner’s obligation to make a Capital Contribution, shall be specially allocated to the Partner. The amount of the interest income shall be excluded from the Capital Contributions credited to the Partner’s Capital Account in connection with the payment of the obligation.

Some draftsmen are concerned that there may be imputed interest on deferred capital contributions. This provision is designed to address this situation. Whether it will work effectively is a matter for speculation. The special allocation may be considered as vitiating the imputed interest rules.


Allocation provisions frequently depend on the order in which they are applied. Clearly set forth the order of application of the various distribution and allocation provisions. This provision is an example:

Section x.x. Order of Application. These provisions shall be applied in this order:

(a) Section y.1.
(b) Section y.2.
(c) Section y.3.
(d) Section y.4.
(e) Section y.5.
(f) Section y.6.
(g) Section y.7.
(h) Section y.8.
(i) Section z.z.

These provisions shall be applied as if all Distributions and allocations were made at the end of the Company’s Fiscal Year. The Capital Account of a Partner shall be determined after the operation of all preceding
provisions for the Fiscal Year where any provision depends on the Capital Account of that Partner.

Consider ordering these provisions when one provision depends on capital accounts as adjusted by another provision. The order of application of allocation provisions can determine the character of income items that are allocated to a preferred return. Distribution provisions (other than liquidating distribution provisions) often should be applied first (before income or loss allocations). Operating distributions often precede distribution of the proceeds of the sale of partnership capital assets. Treasury Regulations require: “Notwithstanding any other provision in this section and section 1.704-1 allocations of partner nonrecourse deductions, nonrecourse deductions, and minimum gain chargebacks are made before any other allocations.”

The first income allocation provision is the minimum gain chargeback. This could be followed by allocations of nonrecourse deductions and then partner nonrecourse deductions.

The next income allocation provision is the partner nonrecourse debt minimum gain chargeback.

The next income allocation provision is the qualified income offset.

The next provision might be the allocation of net operating income (Net Profits) and then the allocation of net operating losses (Net Losses).

The allocation of net operating income might be followed by the allocation of net gain from the sale of partnership capital assets. This gain from sale can be followed by the allocation of net loss from the sale of partnership capital assets.

This ordering permits an allocation of operating income to the preferred return and then fills up any deficiencies in the preferred return with gain from sale, to the extent necessary.

The final provision is the provision for distribution of the proceeds of liquidation.

This ordering ensures that all other allocation and distribution provisions will precede the allocation of liquidation proceeds.

w. Tiered Partnerships.

Tiered partnerships provide special drafting opportunities. Special problems in allocating “book” income result when a parent partnership owns an inter-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

est in a subsidiary partnership. Problems can be particularly acute when a partner has contributed an interest in a subsidiary partnership to a parent partnership. The parent partnership will report the interest in the subsidiary partnership with a “book” value equal to fair market value of the subsidiary partnership interest at time of contribution. The contribution is usually not an event that permits the subsidiary partnership to revalue its assets. A parent partnership may have a revaluation event. A subsidiary partnership apparently is not permitted to revalue its assets at the same time. Few partnership agreements deal adequately with the problems of parent partnerships investing in subsidiary partnerships. This failure may create significant economic problems for the parent partnership on account of the lack of correspondence of “book” income that flows through from the subsidiary partnership and the “book” values of the parent partnership’s assets.

Treasury Regulations provide:

If a partnership contributes section 704(c) property [contributed property with a “book”-tax disparity] to a second partnership (the lower-tier partnership), or if a partner that has contributed section 704(c) property to a partnership contributes that partnership interest to a second partnership (the upper-tier partnership), the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss. Allocations made under this paragraph shall be considered to be made in a manner that meets the requirements of section 1.704-1(b)(2)(iv)(q) (relating to capital account adjustments where guidance is lacking). 642

The capital account maintenance rules contain this provision:

If the rules of this paragraph (b)(2)(iv) fail to provide guidance on how adjustments to the capital accounts of the partners should be made to reflect particular adjustments to partnership capital on the books of the partnership, such capital accounts will not be considered to be determined and maintained in accordance with those rules unless such capital account adjustments are made in a manner that (1) maintains equality between the aggregate governing capital accounts of the partners and the amount of partnership capital reflected on the partnership’s balance sheet, as computed for “book” purposes, (2) is consistent with the underlying economic arrangement of the partners, and (3) is based, wherever practicable, on Federal tax accounting principles. 643

642 Treas. Reg. § 1.704-3(a)(9).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

These provisions do not provide an unambiguous guide to how a parent partnership should compute its “book” income or loss that flows through from a subsidiary partnership when there has been an adjustment to the “book” value of an interest in the subsidiary partnership that is not reflected in the assets of the subsidiary partnership. These provisions suggest a possible approach.

The parent partnership can calculate subsidiary “book” income and loss that is allocated to its partners by allocating any adjustment to “book” value in the subsidiary partnership to the assets of the subsidiary partnership. The parent partnership would calculate its “book” income or loss in effect by applying “book” value adjustments to the assets of the subsidiary partnership on an aggregate basis. This suggests opportunities for a carefully drafted partnership agreement.

x. Tax Treatment of Contributed Property.

Section x.x. Contributed or Revalued Property. Each Partner’s allocable share of the taxable income or loss of the Partnership, depreciation, depletion, amortization and gain or loss with respect to any contributed property (or with respect to revalued property when the Partnership’s property is revalued under Section 1.704-1(b)(2)(iv)(f) of the Treasury Regulations) shall be determined in the manner (and as to revaluations, in the same manner as) described in Section 704(c) of the Code. The Partnership shall apply Section 704(c)(1)(A) by using the “traditional method” (as set forth in Section 1.704-3(b) of the Treasury Regulations).

The partnership tax laws contain special rules that apply to compute tax allocations of depreciation, gain, and loss on property that has been contributed to the partnership in-kind or that has been subject to a revaluation. Treasury Regulations prescribe three basic methods – the traditional method, the traditional method with curative allocations, and the remedial method. Treasury Regulations permit other reasonable allocation methods that are not specifically set forth in Treasury Regulations. The purpose of the rules is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss. A partnership must allocate income, gain, loss, and deduction with respect to property contributed by a partner to the partnership so as to take into account any variation between the adjusted tax basis of the property and its fair market value (at the time of contribution). These allocations must be made using a reasonable method that is consistent with the purpose of the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis. As a general matter, the contributing partner often will prefer the traditional

---

method. The noncontributing partners often will prefer either the curative method or the remedial method. Whatever method the partnership elects, set forth the election in your partnership agreement. Your partnership agreement may permit a manager to make this election. Set forth criteria for the manager to apply in selecting a method.

This provides a useful operational rule for allocating “book” income and “book” losses in accordance with partners’ interests in the partnership. Taxable income and taxable losses should follow “book” allocations generally. The allocation applies the tax rules (Section 704(c)(1)(A)) that apply to contributed property with a “book”-tax disparity (assuming the use of the traditional method):

- Calculate partnership taxable income or taxable losses with respect to each item of partnership property with “book”-tax differences and partnership net taxable income or net taxable losses by excluding items with respect to partnership property with “book”-tax differences.
- Allocate partnership net “book” income or net “book” loss in accordance with the partnership agreement.
- Determine each partner’s share of net “book” income or net “book” loss under the partnership agreement.
- Determine each partner’s share of net “book” income or net “book” loss separately with respect to each partnership asset with a “book”-tax difference.
- Determine each partner’s share of the net “book” income or net “book” loss after excluding items attributable to partnership assets with a “book”-tax difference.
- Identify who is the contributing partner (or deemed contributing partner) and which partners are noncontributing partners with respect to each partnership asset with a “book”-tax difference.
- On an asset-by-asset basis (with respect to assets with a “book”-tax difference [if there was a revaluation event, each partner receiving a revaluation adjustment should be treated as contributor of that portion of the asset, and that portion should be considered a separate asset]), allocate taxable income or taxable loss with respect to the asset with a “book”-tax disparity.
- These rules apply if there is a “book” loss from the asset with a “book”-tax disparity,
  - Allocate items of tax loss (for example, depreciation deductions) from the asset with a “book”-tax disparity (and only
from the asset with a “book”-tax disparity) to noncontributing partners so that (to the extent possible) each noncontributing partner receives a share of tax loss from the asset with a “book”-tax disparity equal to the noncontributing partner’s share of “book” loss from the asset with a “book”-tax disparity. The noncontributing partners’ share of “book” loss from the asset with a “book”-tax disparity may be greater than the tax loss from the asset with a “book”-tax disparity. If so, allocate the tax loss from the asset with a “book”-tax disparity among them pro rata by “book” loss from the asset with a “book”-tax disparity, but stop when you hit the “ceiling rule.”

- Allocate all remaining tax loss with respect to the asset with a “book”-tax disparity to the contributing partner.
- Allocate items of tax income from the asset with a “book”-tax disparity (and only from the asset with a “book”-tax disparity) to noncontributing partners so that (to the extent possible) each noncontributing partner receives a share of tax gain or income from the asset with a “book”-tax disparity equal to the noncontributing partner’s share of “book” gain or income from the asset with a “book”-tax disparity. The noncontributing partners’ share of “book” gain or income from the asset with a “book”-tax disparity may be greater than the gain or income from the asset with a “book”-tax disparity. If so, allocate the tax gain or income from the asset with a “book”-tax disparity among them pro rata by “book” gain or income from the asset with a “book”-tax disparity, but stop when you hit the “ceiling rule.”

- Allocate all remaining tax gain or income with respect to the asset with a “book”-tax disparity to the contributing partner.
- If there is a tax loss with respect to the asset with a “book”-tax disparity, allocate all tax loss with respect to the asset with a “book”-tax disparity to the contributing partner.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Allocate all remaining tax items (not associated with assets with “book”-tax disparity) to the partners in accordance with their shares of net “book” income or net “book” loss, as the case may be.

Slightly different methods apply when you use the curative allocation method or the remedial allocation method.

y. Varying Interests Rule.

Section x.x Allocations Between Transferor and Transferee. Upon the Transfer of all or any part of the Interest of a Partner, Net Profits and Net Losses shall be allocated between the transferor and transferee on the basis of the computation method that is selected in the sole and absolute discretion of the General Partners. The immediately previous sentence is qualified by the requirement that the method be in conformity with the methods permitted by Section 706 of the Code and Treasury Regulations Section 1.706-1(c)(2)(i). Distributions of Distributable Cash shall be made to the holder of record of the Interest on the date of distribution.

Better practice requires that the partnership expressly select a method of applying the varying interests rule:

Section x.x Allocations Between Transferor and Transferee. Upon the Transfer of all or any part of the Interest of a Partner, the Partnership shall allocate Net Profits and Net Losses and all other items of income, gain, deduction and loss between the transferor and transferee on the basis of an interim closing of the books of the Partnership as provided for under Treasury Regulations Section 1.706-1(c)(2)(ii). The Partnership shall make Distributions of Distributable Cash to the holder of record of the Interest on the date of Distribution.

Section 706(d) (the “varying interests” rule) sets detailed rules that prorate items between the transferor and transferee of a partnership interest. The taxable year of your partnership does not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner’s entire interest in the partnership, or the sale or exchange of a partner’s interest in the partnership, except when there is a sale or exchange of a 50 percent or greater interest in partnership capital and profits in a 12-month period. The partnership terminates, when there is a

645 Treas. Reg. § 1.704-1(c)(1) (“Except in the case of a termination of a partnership and except as provided in paragraph (2) of this subsection, the taxable year of a partnership shall not close as the result of the death of a partner, the entry of a new partner, the liquidation of a partner’s interest in the partnership, or the sale or exchange of a partner’s interest in the partnership.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

sale or exchange of a 50 percent or greater interest in the partnership within a 12-month period.\(^{646}\) The partnership taxable year closes for all partners as of the date of termination.\(^{647}\) The closing of the partnership’s taxable year causes all partnership tax items to flow through to partners on the date of that closed taxable year.

The partnership’s taxable year closes with respect to a partner who sells or exchanges his entire interest in a partnership.\(^{648}\) The partnership’s taxable year closes with respect to a partner whose entire interest is liquidated.\(^{649}\)

A partner may sell or exchange his entire interest without a tax termination of the partnership. The partner’s interest in the partnership may be liquidated by the partnership. The partner’s distributive share of partnership tax items and any guaranteed payments, in the case of a sale, exchange, or liquidation of a partner’s entire interest in a partnership, includes in his taxable income for his taxable year within or with which his membership in the partnership ends. The partner’s share of tax items can be computed either by an interim closing of the partnership books or by prorating partnership tax items on a proportional basis. The proration can be undertaken by another reasonable method. The partnership has the burden of proof of showing that the proration method is reasonable. The proration may be based on the portion of the taxable year that has elapsed before the sale, exchange, or liquidation, or may be determined under any other method that is reasonable.\(^{650}\)

This might be a daily proration based on the number of days before and after the transfer. Some partnerships use a half-month convention or a monthly convention. Another method that has been approved by the IRS permits the partnership to al-

\(^{646}\) I.R.C. § 708(b)(1) ("For purposes of subsection (a), a partnership shall be considered as terminated only if—(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (B) within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.").

\(^{647}\) Id.

\(^{648}\) I.R.C. § 706(c)(2)(A) ("The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise). ").

\(^{649}\) Treas. Reg. § 1.704-1(c)(2)(i) ("A partnership taxable year shall close with respect to a partner who sells or exchanges his entire interest in a partnership, and with respect to a partner whose entire interest is liquidated. However, a partnership taxable year with respect to a partner who dies shall not close prior to the end of such partnership taxable year, or the time when such partner’s interest (held by his estate or other successor) is liquidated or sold or exchanged, whichever is earlier. . . .").

\(^{650}\) Treas. Reg. § 1.704-1(c)(1).
locate operating items on the basis of daily prorations, but to allocate extraordinary items (for example, gains or losses from sale of property) based on an interim closing of the books. Treasury Regulations contain this example:

Example. Assume that a partner selling his partnership interest on June 30, 1955, has an adjusted basis for his interest of $5,000 on that date; that his pro rata share of partnership income up to June 30 is $15,000; and that he sells his interest for $20,000. Under the provisions of section 706(c)(2), the partnership year with respect to him closes at the time of the sale. The $15,000 is includible in his income as his distributive share and, under section 705, it increases the basis of his partnership interest to $20,000, which is also the selling price of his interest. Therefore, no gain is realized on the sale of his partnership interest. The purchaser of this partnership interest shall include in his income as his distributive share his pro rata part of partnership income for the remainder of the partnership taxable year.  

Section 706(d) contains special rules that apply to certain tax basis items and certain items with respect to lower-tier partnerships. Section 706(d) provides:

(d) Determination of distributive share when partner’s interest changes

(1) In general. Except as provided in paragraphs (2) and (3), if during any taxable year of the partnership there is a change in any partner’s interest in the partnership, each partner’s distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

(2) Certain cash basis items prorated over period to which attributable

(A) In general. If during any taxable year of the partnership there is a change in any partner’s interest in the partnership, then (except to the extent provided in regulations) each partner’s distributive share of any allocable cash basis item shall be determined—

(i) By assigning the appropriate portion of such item to each day in the period to which it is attributable, and

---

651 Treas. Reg. § 1.706-1(c)(2)(ii).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(ii) By allocating the portion assigned to
any such day among the partners in proportion to their interests in the
partnership at the close of such day.

(B) Allocable cash basis item. For purposes of
this paragraph, “allocable cash basis item” means any of the following
items with respect to which the partnership uses the cash receipts and dis-
bursements method of accounting:

(i) Interest.
(ii) Taxes.
(iii) Payments for services or for the use
of property.

(iv) Any other item of a kind specified in
regulations prescribed by the Secretary as being an item with respect to
which the application of this paragraph is appropriate to avoid significant
misstatements of the income of the partners.

(C) Items attributable to periods not within tax-
able year. If any portion of any allocable cash basis item is attributable to–

(i) Any period before the beginning of
the taxable year, such portion shall be assigned under subparagraph
(A)(i) to the first day of the taxable year, or

(ii) Any period after the close of the tax-
able year, such portion shall be assigned under subparagraph (A)(i) to the
last day of the taxable year.

(D) Treatment of deductible items attributable to
prior periods. If any portion of a deductible cash basis item is assigned
under subparagraph (C)(i) to the first day of any taxable year–

(i) Such portion shall be allocated
among persons who are partners in the partnership during the period to
which such portion is attributable in accordance with their varying inter-
ests in the partnership during such period, and

(ii) Any amount allocated under clause
(i) to a person who is not a partner in the partnership on such first day
shall be capitalized by the partnership and treated in the manner provided
for in section 755.

(3) Items attributable to interest in lower tier part-
nership prorated over entire taxable year. If–
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(A) During any taxable year of the partnership there is a change in any partner’s interest in the partnership (hereinafter in this paragraph referred to as the “upper tier partnership”), and

(B) Such partnership is a partner in another partnership (hereinafter in this paragraph referred to as the “lower tier partnership”),

then (except to the extent provided in regulations) each partner’s distributive share of any item of the upper tier partnership attributable to the lower tier partnership shall be determined by assigning the appropriate portion (determined by applying principles similar to the principles of subparagraphs (C) and (D) of paragraph (2)) of each such item to the appropriate days during which the upper tier partnership is a partner in the lower tier partnership and by allocating the portion assigned to any such day among the partners in proportion to their interests in the upper tier partnership at the close of such day.

(4) Taxable year determined without regard to subsection (c)(2)(A). For purposes of this subsection, the taxable year of a partnership shall be determined without regard to subsection (c)(2)(A).

z. Excess Nonrecourse Liabilities.

Section x.x. Allocation of Liabilities. “Excess nonrecourse liabilities” of the Partnership shall be allocated among the Partners in accordance with their Percentage Interests. “Excess nonrecourse liabilities” mean “excess nonrecourse liabilities” as used in Section 1.752-3(a)(3) of the Treasury Regulations.

Excess nonrecourse liabilities are liabilities allocable under the third tier under the liability allocation Treasury Regulations under the partnership rules for allocating liabilities among partners (Section 752). The partnership has considerable flexibility in defining interests in profits for purposes of allocating excess nonrecourse liabilities.652

652 Treas. Reg. § 1.752-3(a)(3) (“The partner’s share of the excess nonrecourse liabilities (those not allocated under paragraphs (a)(1) and (a)(2) of this section) of the partnership as determined in accordance with the partner’s share of partnership profits. The partner’s interest in partnership profits is determined by taking into account all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities provided the interests so specified are reasonably consistent with allocations (that (footnote continued on the next page)
63. Consistency of Treatment.

Your partnership agreement might provide for a contractual requirement of consistent treatment by the partners:

Section x.x. Consistent Treatment. Each Partner is aware of the income tax consequences of the allocations made by this Article X. Each Partner shall be bound by this Article X in reporting its share of Partnership income and loss for income tax purposes. No Partner shall report on its tax return any transaction by the Partnership, any amount allocated or distributed from the Partnership or contributed to the Partnership inconsistently with the treatment reported by the Partnership on its tax return. No Partner shall take a position for tax purposes that is inconsistent with the position taken by the Partnership.

64. Guaranteed Payments.

A guaranteed payment is a payment that a partnership makes to a partner either for services or for the use of capital that is determined without regard to the have substantial economic effect under the section 704(b) regulations) of some other significant item of partnership income or gain. Alternatively, excess nonrecourse liabilities may be allocated among the partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Additionally, the partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on section 704(c) property (as defined under section 1.704-3(a)(3)(ii)) or property for which reverse section 704(c) allocations are applicable (as described in section 1.704-3(a)(6)(i)) where such property is subject to the nonrecourse liability to the extent that such built-in gain exceeds the gain described in paragraph (a)(2) of this section with respect to such property. This additional method does not apply for purposes of section 1.707-5(a)(2)(ii). To the extent that a partnership uses this additional method and the entire amount of the excess nonrecourse liability is not allocated to the contributing partner, the partnership must allocate the remaining amount of the excess nonrecourse liability under one of the other methods in this paragraph (a)(3). Excess nonrecourse liabilities are not required to be allocated under the same method each year.”). Consider the possibility of allocating excess nonrecourse liabilities in accordance with allocations of built-in gain (as provided above in the quoted provision from the Treasury Regulations).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

income of the partnership. Be clear in identifying any payments (for example, fees to a managing partner) that are treated as “guaranteed payments” for tax purposes. Your partnership may deduct a guaranteed payment as an ordinary deduction or it may be required to capitalize the payment in the tax basis of property. The guaranteed payment will be ordinary income to the partner who receives the guaranteed payment.

Section x.x. Guaranteed Payment to General Partner. In consideration for its services of acting as General Partner of the Partnership, the General Partner shall receive a monthly payment of $1,000,000. This payment shall be prorated for periods of less than one month. For income tax reporting purposes, this payment to the General Partner shall be regarded as a guaranteed payment under Section 707(c) of the Code.

A guaranteed payment is determined “without regard to the income of the partnership.” Guaranteed payments include both payments to a partner for services and payments to a partner for the use of capital. Guaranteed payments are considered as made to one who is not a member of the partnership, but only for the purposes of Section 61(a) (relating to gross income) and, subject to Section 263, for purposes of Section 162(a) (relating to trade or business expenses). A distinguishing characteristic is that guaranteed payments should be payable in all events.

---

653 I.R.C. § 707(c); Treas. Reg. § 1.707-1(c).
654 I.R.C. § 707(c). See also Treas. Reg. § 1.707-1(c).
655 See footnote continued on the next page.

Guaranteed payments are includible as ordinary income by the recipient partner for his taxable year within or with which ends the partnership taxable year in which the partnership deducted the payments as paid or accrued under its method of accounting. Guaranteed payments are generally deductible by the partnership (in accordance with the partnership’s accounting method), but deductibility can be limited. Deductibility of a guaranteed payment is limited by the tests of deductibility of Section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of Section 263 (relating to capital expenditures). A partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. Partnership case law, statutory law and administrative law are not clear on whether someone whose only interest in a partnership is a claim to a guaranteed payment should be treated as a partner of the partnership.

A guaranteed payment must be made to a partner. A guaranteed payment may be made for services or as a return on capital. A critical element in distinguishing a payment as a guaranteed payment is that the payment is made without regard to

(footnote continued on the next page)
Treasury Regulations include this example of guaranteed payment:

Example (1). Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of $10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has $50,000 ordinary income. A must include $15,000 as ordinary income for his taxable year within or with which the partnership taxable year ends ($10,000 guaranteed payment plus $5,000 distributive share).

Guaranteed payments do not depend on partnership income. A payment that depends on partnership income is not a guaranteed payment, but normally is a partnership distribution. When a payment depends on partnership income can be

the income of the partnership. Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent that the payments are determined without regard to the income of the partnership. A partner must include guaranteed payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted the payments as paid or accrued under its method of accounting.

Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of Section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses).

Guaranteed payments still are subject to normal requirements for deductibility by the partnership. To be deductible, the guaranteed payment must meet the same tests for deductibility as ordinary and necessary business expenses under Section 162(a) as it would if the payment had been made to a person who is not a member of the partnership. Deductibility of guaranteed payments is still subject to the capitalization rules of Section 263. This rule does not affect the deductibility to the partnership of a payment described in Section 736(a)(2) to a retiring partner or to a deceased partner’s successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of Sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner’s distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. Treas. Reg. § 1.704-1(c).

\[656\]  

Treas. Reg. § 1.707-1(c), Example (1).
uncertain. A preferred return payable out of partnership cash flow may not be a
guaranteed payment. There additionally is a concept that a guaranteed payment
is a guaranteed payment. A guaranteed payment should be payable in all events. A manage-
ment fee of 3% of a partnership’s real property rentals does not depend on the in-
come of the partnership and is not a guaranteed payment. Guaranteed payments
are deductible by the partnership in accordance with its method of accounting. The
partner’s includibility of the guaranteed payment (as ordinary income) de-
dpends on when the guaranteed payment is recognized as a deduction by the part-
nership. The partner may report income prior to the partnership’s deduction when
the partnership is required to capitalize the guaranteed payment. This can occur,
for example, when the underlying services are of a nature that the payment would
be capitalized if a payment were made to a third party for the same services.

Partners often receive preferred returns for capital. These preferred returns
may be drafted either as guaranteed payments or as preferred distributions of
partnership cash flow coupled with preferred allocations of partnership income
(either net income or gross income). This requires an analysis of whether the
payment is dependent on partnership income and whether the payments are paya-
ble in all events. Payments that are a return on capital that are not dependent on
partnership income and that are payable in all events should be characterized as
guaranteed payments. Preferred return payments that are superior in liquidation
priority to return of capital of some investors often will be taxed as guaranteed
payments. Guaranteed payments for capital may be subject to capitalization under
the uniform capitalization rules of Section 263A.

65. Tax Protection Agreement.

Tax protection agreements may be contained in your partnership agree-
ment or in a separate document. Tax protection agreements typically relate to the
partner’s latent tax on gain associated with a “book”-tax disparity (Section 704(c)
gain). Tax protection agreements apply if the partnership recognizes Section
704(c) gain that is allocated to the contributing partner during a specified
lock-up period. These agreements may be long, complex and difficult to draft.
They rarely consider all of the applicable considerations. These are some of the
issues that often are involved:

657 Investors Insurance Agency, Inc. v. Commissioner, 72 T.C. 1027 (1979),
aff’d, 677 F2d 1328 (9th Cir. 1982).
658 See Pratt v. Commissioner, 64 TC 203 (1975), aff’d, 550 F2d 1023 (5th
Cir. 1977). But see Rev. Rul. 81-300, 1981-2 CB 143 (IRS will not follow Pratt).
659 Treas. Reg. § 1.707-1(c).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What is the measure of income on which tax indemnification payments are made? This often is limited to Section 704(c) gain (gain associated with a “book”-tax basis disparity), reduced by basis offsets to contributed property on account of adjustments under the basis adjustment rules of Section 734 (on a distribution of partnership property to a partner) or the basis adjustment rules of Section 743 (on the sale or exchange of a partnership interest or the death of a partner). (Gain on which indemnification payments are made perhaps should include gain recognized under Section 751(b) (collapsible partnership rules) and under disguised sale rules.) The tax protection agreement might indemnify contributors against the effects of dispositions of contributed property by the partnership on pre-contribution like-kind exchanges. The indemnified tax amount should be stated clearly.

- Clear statement of the period during which the tax protection applies. No universal standard exists.

- Notional combined federal and state tax rate. The indemnification often is made at the combined effective rates that apply to the maximum bracket of income of the type indemnified. Allow for federal deductibility of state income taxes. Consider the different rates that apply to capital gains, Section 1231 gains, dividends, and excess Section 1250 amounts. Consider possible repeal of the federal deduction for state taxes. Consider effects of alternative minimum tax.

- Future rate changes (including rate changes midway through the partnership’s taxable year, so that income realized early in the partnership’s taxable year may be taxed at one rate and income realized late in the partnership’s taxable year may be taxed at another rate).

- Future tax surcharges on top of regular rates.

- Dealing with different types of contributors (individuals, trusts, estates, and corporations).

---

660 The IRS might contend that a post-contribution disposition of contributed replacement property might invalidate a pre-contribution like-kind exchange.

661 Consider both state of residency of the partner and state in which the property is located. Some states impose income tax on worldwide income but credit state taxes paid to other states.

662 Consider effects of the alternative minimum tax on these provisions.
Dealing with pass-through entities as contributors.

Dealing with the possibility that a transaction may be nontaxable for federal tax purposes but taxable for state tax purposes.

Quarterly cash indemnification payments for estimated tax.

When indemnification payments are to be made (including indemnification payments that relate to estimated tax payments, annual tax payments, and payments that result from audit adjustments).

Special treatment of and indemnification from interest charges under Section 453A on account of an installment sale.

What procedure should be followed if a readjustment is made on audit or in litigation. Who will control defense? This can be a particularly touchy issue if the tax liability is resolved in an audit of the partner personally and not a TEFRA audit of the partnership (which particularly can be the case with state tax proceedings if the state in question has not conformed to federal TEFRA audit procedures). Defense provisions may be extensive and highly detailed. They can include who controls defense, cooperation with defense, who selects counsel, extensions of statutes of limitations, powers of attorney, participation, notices, ability to settle or compromise, whether deposits or escrows are required in order to settle or compromise, choice of forum, who bears expenses, when expenses are reimbursed, what evidence is required for reimbursement, how to handle items under audit that may not relate to partnership activities, etc.

Whether the indemnification extends to tax penalties and interest if an adjustment is made on audit or in tax litigation.

Claw back on tax indemnification payments if an audit adjustment reduces indemnified gains.

The extent to which the indemnification will extend to transferees, heirs, etc. of the original contributors.

Whether a transfer of a certain percentage of interests in the partnership will void the indemnifications.

Whether a clawback applies to prior indemnification payments if the partner later transfers part of all of his partnership interest (and otherwise would have recognized the built-in gain).

Whether indemnification payments will consider the state of residence of the partner – or whether a common state residence is agreed.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Whether losses generated by the partnership will affect indemnification payments.
- Effects of Section 734 basis adjustments and Section 743 basis adjustments on indemnification payments.
- The replacement property will be subject to the tax protection agreement in the same manner as the property that was exchanged if property is received in a nontaxable transaction in exchange for Section 704(c) property (property contributed with a “book”-tax disparity).
- There may be a procedure for submitting computations or tax issues to an independent professional for calculation of indemnification payments or determination of tax liability.
- The contributors may want the partnership to commit that it will make a Section 754 basis adjustment election in order to reduce or to eliminate future exposure to allocations of gain associates with a “book”-tax disparity (Section 704(c) exposure).


Section x.x. Tax Matters Partner.

(a) Designation. As long as he qualifies as tax matters partner under the Code, * * * * shall be the Tax Matters Partner. If no person shall be serving as Tax Matters Partner, the Person meeting the requirements for a tax matters partner under Code Section 6231(a)(7) and designated by vote of Members owning a majority of the Percentage Interests of the Members shall become the Tax Matters Partner. The Tax Matters Partner may resign upon thirty (30) days’ prior written notice to the other Members.

(b) Powers. The Tax Matters Partner has all of the powers and authority of a tax matters partner under the Code. The Tax Matters Partner shall represent the Company in connection with all administrative and/or judicial proceedings instituted by the Internal Revenue Service or any taxing authority involving any tax return of the Company. This representation shall be at the Company’s expense. The Tax Matters Partner may expend the Company’s funds for professional services and costs associated with any administrative and/or judicial proceedings instituted by the Internal Revenue Service or any taxing authority involving any tax return of the Company. The Tax Matters Partner shall provide to the Members prompt notice of any communication to or from or agreements with a
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

federal, state or local taxing authority regarding any tax return of the
Company (including a summary of the communication).

Partnerships may be subject to tax audits at the partnership level. An ex-
ception is made for any partnership having ten or fewer partners, each of whom is
an individual (other than a nonresident alien), a C corporation, or an estate of a
deceased partner. Husband and wife (and their estates) are treated as one partner.
These small partnerships are not subject to the consolidated audit rules unless they
make a specific election. Otherwise, partnerships are audited at the partnership
level in a consolidated proceeding, often referred to as a “TEFRA audit.” The tax
treatment of any partnership item (and the applicability of any penalty, addition to
tax, or additional amount that relates to an adjustment to a partnership item) is
generally determined at the partnership level for partnerships subject to TEFRA
audits.663

Partners of TEFRA partnerships are required (on their individual tax re-
turn) to treat a partnership item in a manner that is consistent with the treatment of
the partnership item on the partnership return.664 This requirement of consistent
treatment does not apply if –

- The partnership has filed a return but the partner’s treatment on his
  return is (or may be) inconsistent with the treatment of the item on
  the partnership return, or the partnership has not filed a return, and
- The partner files with the Secretary a statement identifying the in-
  consistency.665

The key representative of the partnership in a TEFRA partnership tax a-
udit is the tax matters partner. One of the principal roles of the tax matters partner
is to ensure that the partners are forwarded notices from the IRS relating to a part-
nership audit. The tax matters partner is required to keep each partner informed of
all administrative and judicial proceedings for the adjustment at the partnership
level of partnership items.

Any partner has the basic right to participate in any TEFRA adminis-
trative proceeding relating to the determination of partnership items at the partner-
ship level.666 This right can be waived.667 A partner may waive any right under the

663 I.R.C. § 6221.
664 I.R.C. § 6222(a).
665 I.R.C. § 6222(b)(1).
666 I.R.C. § 6224(a). See Treas. Reg. § 1.301.6224(a)-1(a) (“Sec.
301.6224(a)-1 Participation in administrative proceedings. (a) In general. Every
partner in the partnership, including an indirect partner, has the right to participate
in any phase of administrative proceedings. However, except as provided in sec-
(footnote continued on the next page)
TENFRA audit procedural rules, if this waiver is made on the form provided for this purpose.\textsuperscript{668} The effects of prior agreements contained in the partnership agreement by a partner to waive TEFRA audit rights have not been clarified by court decisions. These agreements may technically bind the partner. It is unclear whether they will be respected by the IRS. These agreements do not conform to the requirements of Section 6224. These agreements may not be specifically enforced by a court.

The TEFRA audit rules give the tax matters partner general authority to enter into settlements of partnership items with the IRS. The settlement agreement binds all partners when the tax matters partner enters into a settlement agreement with the IRS with respect to partnership items (including partnership-level determinations relating to any penalty, addition to tax, or additional amounts that relate to adjustments to partnership items) and expressly states that the agreement binds the other partners.\textsuperscript{669} This general rule does not apply to these exceptional situations:

- A situation in which there a showing of fraud, malfeasance, or misrepresentation of fact.

\textsuperscript{667} Treas. Reg. § 1.197-2(d)(2)(ii)(A).
\textsuperscript{668} Treas. Reg. § 1.301.6224(b)-1(a). If no form is furnished by the IRS, the partner’s written statement shall – (1) be clearly identified as a waiver under Section 6224(b); (2) identify the partner and the partnership by name, address, and taxpayer identification number; (3) specify the right or restriction being waived and the taxable year(s) to which the waiver applies; (4) be signed by the partner making the waiver; and (5) be filed with the service center where the partnership return is filed.\textsuperscript{668} Treas. Reg. § 1.301.6224(b)-1(b).

If the partner filing the waiver statement knows that the notice described in section 6223(a)(1) (beginning of an administrative proceeding) has already been mailed to the tax matters partner, the waiver statement is required to be filed with the IRS office that mailed the notice.\textsuperscript{668} \textit{Id.}

\textsuperscript{669} Treas. Reg. § 1.301.6224(c)-1(a).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- With respect to partners who (as of the day on which the agreement is entered into) either were notice partners or members of a notice group,

- With respect to partners who have filed with the IRS (at least 30 days before the day on which the agreement is entered into) a statement not to be bound by the settlement agreement.670

The TEFRA rules permits the tax matters partner to file a petition for readjustment within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner. The tax matters partner may file a petition for a readjustment of the partnership items for the taxable year with the Tax Court, the district court of the United States for the district in which the partnership’s principal place of business is located, or the Claims Court.671 Any notice partner (and any 5-percent group) may file (within 60 days after the close of the 90-day period) a petition for a readjustment of the partnership items for the taxable year involved with any of these courts, when the tax matters partner does not file this readjustment petition with respect to any final partnership administrative adjustment.672 The tax matters partner is permitted to intervene in this action.673

The district court or claims court has jurisdiction over a readjustment petition only if the partner filing the petition deposits, on or before the day the petition

670 Treas. Reg. § 1.301.6224(c)-1(a); Treas. Reg. § 1.301.6224(c)-1(c) (“Statement not to be bound – (1) Contents of statement. The statement referred to in paragraph (a)(2) of this section shall – (i) Be clearly identified as a statement to deny settlement authority to the tax matters partner under section 6224(c)(3)(B); (ii) Identify the partner and partnership by name, address, and taxpayer identification number; (iii) Specify the taxable year or years to which the statement applies; and (iv) Be signed by the partner filing the statement. (2) Place where statement is to be filed. The statement described in paragraph (c)(1) of this section generally shall be filed with the Internal Revenue Service service center where the partnership return is filed. However, if the partner knows that the notice described in section 6223(a)(1) (beginning of an administrative proceeding) has already been mailed to the tax matters partner, the statement shall be filed with the Internal Revenue Service office that mailed that notice. (3) Consolidated statements. The statement described in paragraph (c)(1) of this section may be filed with respect to more than one partner if the requirements of that paragraph (c)(1) (including signatures) are satisfied with respect to each partner.”).

671 I.R.C. § 6226(a).

672 I.R.C. § 6226(b).

673 I.R.C. § 6226(b)(6).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tion is filed, the amount by which the tax liability of the partner would be increased if the treatment of partnership items on the partner’s return were made consistent with the treatment of partnership items on the partnership return, as adjusted by the final partnership administrative adjustment. This requirement applies to each member of the group when a petition filed by a 5-percent group.

The tax matters partner may file a request for an administrative adjustment on behalf of the partnership on the form prescribed by the Internal Revenue Service for that purpose in accordance with that form’s instructions.

Consider whether the partners of your partnership should agree to make the election to be subject to the consolidated TEFRA audit rules if your partnership qualifies as a small partnership that is not otherwise subject to the TEFRA audit rules. Address the participation of the partnership in TEFRA audits if your partnership makes this election to be included under the TEFRA audit rules, or if your partnership otherwise is subject to the TEFRA audit rules.

This is a short-form TEFRA audit provision:

Section x.x. Tax Matters of the Company.

(a) The Manager shall appoint and has the power to remove the Tax Matters Partner. The initial Tax Matters Partner shall be *****, who shall serve until ***** resigns or is removed under this Section x.x. The Manager may remove the Tax Matters Partner (at the Manager’s sole and absolute discretion). The Tax Matters Partner also may be removed at any time (but only for Cause) by the affirmative vote or written consent of a majority of the other Members (that is by majority [by Percentage Interest] of those Members other than the Tax Matters Partner).

(b) For purposes of the preceding sentence, “Cause” is defined as any of these events:

(i) The Tax Matters Partner’s failure (by reason of physical or mental impairment) substantially to perform the material duties of the Tax Matters Partner for a period of thirty (30) consecutive days or for any sixty (60) days (whether or not consecutive) in a three hundred sixty-five (365) day period.

(ii) The Tax Matters Partner’s intentional or reckless disregard of material duties as Tax Matters Partner or the Tax Matters Partner’s failure to perform material duties as Tax Matters Partner due to wrongful neglect;

674 I.R.C. § 6226(e)(1).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(iii) The Tax Matters Partner’s commission of a felony (whether or not involving moral turpitude) or a misdemeanor (involving moral turpitude).

(iv) The Tax Matters Partner’s commission of any misdemeanor (whether or not involving moral turpitude) involving the business of the Company.

(v) The Tax Matters Partner’s commission of an act of fraud or dishonesty with respect to the Tax Matters Partner’s duties under this Agreement.

(vi) The Tax Matters Partner’s material breach of a provision of this Agreement.

For purposes of Section x.x(b), “commission” shall include (without prejudice to generality) the Tax Matters Partner’s being charged by indictment or information, or the Tax Matters Partner’s being convicted (including (without prejudice to generality) by entry of a plea of guilty or nolo contendere).

(c) The Tax Matters Partner shall be responsible for undertaking the statutory responsibilities of the “Tax Matters Partner” under Subchapter C of Section 63 of Subtitle F of the Code (as set forth in the Code and the Treasury Regulations).

The Tax Matters Partner shall fully comply with the requirements of Treasury Regulations Section 301.6223(g)-1 and any successor provision.

The Tax Matters Partner shall represent the Company in connection with all examinations of the Company’s affairs by tax authorities and all administrative and/or judicial proceedings by the Internal Revenue Service or any government authority involving any income tax return of the Company. This representation shall be at the Company’s expense. The Tax Matters Partner may expend the Company’s funds for professional services and costs associated with all examinations of the Company’s affairs by tax authorities and all administrative and/or judicial proceedings by the Internal Revenue Service or any government authority involving any income tax return of the Company.

(d) The Company may not have adequate funds for financing the Tax Matters Partner’s representation of the Company in connection with tax examinations and/or judicial proceedings. Then, the Tax Matters Partner shall make one or more calls on the Members (or former Members, if the Company has dissolved) to contribute sufficient funds to fi-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

nance the representation of the Company in connections with tax examinations and/or judicial proceedings.

Each Member (within ten (10) business days of the receipt of written notice of the call) shall contribute its share of the total call in immediately available funds (in United States dollars).

Each Member’s share of a call shall equal the product of its Percentage Interest and the total amount of the call for funds.

This obligation to meet calls to fund the representation of the Company in connection with examinations and/or judicial proceedings shall survive the winding up and dissolution of the Company.

(e) The Tax Matters Partner has the authority to do any of these acts (without prejudice to generality):

(i) To enter into a settlement agreement with the Internal Revenue Service that binds those Members that are not notice Members (as defined in Section 6231(a)(8) of the Code);

(ii) To file a petition as contemplated in Section 6226(a) or 6228 of the Code;

(iii) To intervene in any action as contemplated in Section 6226(b)(6) of the Code;

(iv) To file any request contemplated in Section 6227(c) of the Code; or

(v) To enter into an agreement extending the period of limitations as contemplated in Section 6229(b)(1)(B) of the Code.

(f) The Tax Matters Partner shall promptly provide to the other Members –

(i) Copies of any agreements it enters into or filings it makes on behalf of the Company and

(ii) Written notice of its intervention in any action referred to in the immediately preceding paragraph.

(g) The Tax Matters Partner shall promptly furnish to each Member information with respect to these events and actions (in the case of any action, within five (5) business days after taking that action):

(i) Closing Conferences. Closing conferences with the examining agent.

(iii) Appeals Conferences. Time and place of any appeals conference.

(iv) Acceptance. Acceptance by the Internal Revenue Service (the “Service”).

(v) Extensions. Consent to the extension of the period of limitations with respect to all Members.

(vi) Adjustments. Filing of a request for administrative adjustment on behalf of the Company or a Member under Temporary Treasury Regulations Section 301.6227(b)-2T.

(vii) Judicial Reviews. Filing by the Tax Matters Partner or any other Member of any petition for judicial review under Code Section 6226 or 6228(a).

(viii) Appeals. Filing of any appeal with respect to any judicial determination provided for in Code Section 6226 or 6228(a).

(ix) Final Judicial Determinations. Any final judicial determination.

(h) The Tax Matters Partner shall provide to the Members prompt notice of any communication to or from a federal, state or local authority regarding any income tax return of the Company.

(i) Any Member has the right to be present at all stages of administrative and/or judicial proceedings involving an income tax return of the Company.

(j) The Tax Matters Partner shall keep each Member informed of all administrative and judicial proceedings for the adjustment at the Company level of Company items.

(k) When the Company is a pass-thru Member of another partnership and receives a notice of a Partnership proceeding with respect to that other Partnership, the Tax Matters Partner shall promptly (within thirty days of receiving that notice) forward copies of the notice to the Members of the Partnership.

(l) If for any reason the Tax Matters Partner can no longer serve in that capacity, the Manager may designate another Member to be Tax Matters Partner. The immediately previous sentence is qualified by the requirement that the Member meets the requirements set forth in the Code and Treasury Regulations to serve as Tax Matters Partner.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(m) All determinations and acts made by (and all omissions of) the Tax Matters Partner, shall be final and binding on the Company and the Members in all respects and for all purposes.

(n) The Tax Matters Partner shall not be required to take any action or incur any expenses for the prosecution of any administrative or judicial remedies in its capacity as Tax Matters Partner unless the Company reserves sufficient funds for the action or expenses or the Members agree on a method of sharing expenses incurred in connection with the prosecution of the remedies (satisfactory in all respects to the Tax Matters Partner).

(o) As long as the Tax Matters Partner is not negligent and acts in good faith, the Company shall indemnify and hold harmless the Tax Matters Partner from and against any and all liabilities incurred by the Tax Matters Partner in connection with any activities or undertakings taken by it in its capacity as Tax Matters Partner.

(p) The Tax Matters Partner may file (in its capacity as Tax Matters Partner and without the need to seek the consent of the other Members) a petition under Section 6226 [a petition for a readjustment of the Partnership items for the taxable year with the Tax Court, the district court of the United States for the district in which the Partnership’s principal place of business is located, or the Claims Court], 6228 [if any part of an administrative adjustment request filed by the Tax Matters Partner under subsection (c) of section 6227 is not allowed by the Secretary, the Tax Matters Partner may file a petition for an adjustment with respect to the Partnership items to which the part of the request relates with the Tax Court, the district court of the United States for the district in which the principal place of business of the Partnership is located, or the Claims Court], or other Sections of the Code with respect to any Company item, or other tax matters involving the Company.

(q) The Tax Matters Partner may bind those Members that are not notice Members (as defined in Section 6231(a)(8) of the Code) to a settlement agreement without obtaining the written concurrence of the other Members that would be bound by that agreement. Any Member who does not wish to be bound by a settlement agreement entered into by the Tax Matters Partner has the opportunity to file (under Section 6224(c)(3)(B) of the Code) with the Secretary of the Treasury a statement that provides that the Tax Matters Partner does not have the authority to enter into a settlement agreement on behalf of the Member. Any other Member that enters into a settlement agreement with the Secretary of the Treasury with respect to any Company items (as defined by Section 6231(a)(3) of the Code) shall notify the Tax Matters Partner and the
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

other Members of that settlement agreement and its terms within ten (10) business days from the date of settlement.

(r) The tax treatment of any Company item shall be determined at the Company level (except as otherwise required in the Code). The Tax Matters Partner is authorized to make elections necessary for a consolidated resolution of federal or state income tax issues at the Company level in a consolidated proceeding.

(s) Members shall furnish the Tax Matters Partner with the information that the Tax Matters Partner may request to permit it to provide the Internal Revenue Service with sufficient information to allow proper notice to the Members in accordance with Section 6223 of the Code and such other information as the Tax Matters Partner may need to report the income and losses of the Company in accordance with applicable federal, state, and local tax law. This includes (without prejudice to generality) the information specified in Section 6230(e) of the Code.

(t) Each Member shall cooperate fully with the Tax Matters Partner in connection with any audit, court action, or appeal regarding the determination of the income of the Company and shall provide to the Tax Matters Partner the information that the Tax Matters Partner may reasonably request.

(u) Each Member is aware of the income tax consequences of the allocations made by this Agreement and shall be bound by this Agreement in reporting his share of Company income, gain, loss, deduction and credit for income tax purposes. No Member shall report on his tax return any transaction by the Company, any amount allocated or distributed from the Company or contributed to the Company inconsistently with the treatment reported (or to be reported) by the Company on its tax return nor take a position for tax purposes that is inconsistent with the position taken by the Company. Every Member will (on the Member’s income tax return) treat a Company tax item in a manner that is consistent with the treatment of the item on the Company’s income tax return.

(v) No Member shall file a Notice of Inconsistent Treatment under Section 6222(b) of the Code.

(w) The Tax Matters Partner shall notify all other Members before filing (under Section 6227 of the Code) a Request for Administrative Adjustment of Company items for any Company taxable year. The Tax Matters Partner shall file the Request for Administrative Adjustment on behalf of the Company if all other Members agree with the requested adjustment. Any Member (including (without prejudice to generality) the Tax Matters Partner) may file a Request for Administrative Adjustment on its
own behalf if unanimous consent is not obtained within thirty (30) days (or, if shorter, within the period required to timely file the Request for Administrative Adjustment).

(x) Any Member intending to file a petition under Sections 6226, 6228, 6234 or other Sections of the Code with respect to any Company item, or other tax matters involving the Company, shall notify the other Members at least ten (10) business days in advance of filing of that intention and the nature of the contemplated proceeding.

(y) Any Member who intends to seek review of any court decision rendered as a result of the proceeding instituted under the preceding part of this Section x.x, shall notify the Tax Matters Partner and the other Members of that intended action at least ten (10) business days in advance of filing a petition for review.

(z) Any Member (including (without prejudice to generality) an indirect Member) has the right to participate in any administrative proceeding relating to the determination of Partnership items at the Partnership level. Every Member in the Partnership (including (without prejudice to generality) an indirect Member) has the right to participate in any phase of administrative proceedings. The Tax Matters Partner shall provide timely notice of any proceeding to the Members. The Internal Revenue Service and the Tax Matters Partner will determine the time and place for all administrative proceedings. Arrangements will generally not be changed merely for the convenience of another Member.

(aa) This Section x.x shall survive the termination of the Company or the termination of any Member’s interest in the Company. This Section x.x shall remain binding on the Members for a period of time necessary to resolve any and all matters regarding the federal and, if applicable, state income taxation of the Company.

(bb) The Company shall retain its tax records with respect to each Fiscal Year for a period of at least ten (10) years.

This is another short TEFRA audit provision:

Section x.x  Tax Matters Member.

(a) The Manager is designated the “Tax Matters Partner” (as defined in Code Section 6231 and for purposes of this Agreement defined as the “Tax Matters Members”), and, subject to the further terms of this Section x.x, is authorized and required to represent the Company (at the Company’s expense) in connection with all examinations of the Company’s affairs by tax authorities, including, without prejudice to generality, administrative and judicial proceedings, subject to the further terms of this
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Section x.x, and to expend Company funds for professional services and costs associated therewith. The Members agree to cooperate with each other and to do or refrain from doing any and all things reasonably required to conduct such proceedings. The Manager shall not take any action or audit position as the Tax Matters Member which would have a material adverse impact on *** Member without the consent of *** Member. All expenses incurred in connection with any such audit and with any other tax investigation, settlement or review shall be borne by the Company.

(b) In the event that the Company shall be the subject of a partnership-level audit by any federal, state or local taxing authority (such as an audit pursuant to the TEFRA audit rules of Subchapter C of Chapter 63 of the Internal Revenue Code), to the extent that the Company is treated as an entity for purposes of such audit, including administrative settlement and judicial review, the Tax Matters Member shall be authorized to act for, and its decision shall be final and binding upon, the Company and each Member thereof; provided, however, that the Tax Matters Member (i) shall notify the Members of any administrative proceeding with respect to the Company pursuant to Section 6223(c) of the Code, (ii) shall promptly furnish the Members with any material correspondence or communication relating to the Company from the Internal Revenue Service received by the Tax Matters Member, (iii) shall consult with the other Members prior to taking any material action relating to the tax affairs of the Company, and (iv) shall make all decisions affecting the tax affairs of the Company in good faith using its reasonable business judgment (it being understood and agreed that for the purposes of this Agreement, the term “reasonable business judgment” shall refer to the “business judgment rule” as the same would be applied under applicable law if the Person in question were a director of a corporation). If the Company does not have sufficient assets to pay the costs of the audit, administrative settlement or judicial review, then the Members shall contribute all needed funds for the prosecution of the audit, administrative settlement or judicial review within five (5) business days upon call of the Tax Matters Member, which call shall require that such contributions be made by the Members in accordance with their Percentage Interests for the tax period under examination (or the arithmetic average of their Percentage Interests for the tax period under examination if more than one taxable year shall be under examination). The immediately previous sentence shall be a continuing covenant that shall survive the winding up and dissolution of the Company.

(c) The Tax Matters Member shall have the right to control any TEFRA audit on behalf of the Company under Treasury Regulations.
Section 301.6224(a)-1(a), to extend the Company statute of limitations under Code Section 6229(b)(1)(B), to select the forum for litigation of the Company's tax dispute subject to TEFRA audit rules under Code Section 6226(a), to file a refund claim on behalf of the Company under Code Section 6228(a), and to settle the Company adjustments for all Members under Code Section 6224(c)(3). A Member who is not a “notice partner” (and not a member of a “notice group” described in Code Section 6223(b)(2)) shall be bound by any settlement agreement which is entered into by the Tax Matters Member, and in which the Tax Matters Member expressly states that such agreement shall bind the other Members. The Tax Matters Member also shall have the notice responsibilities provided for under Treasury Regulations Section 301.6223(g)-1. The Tax Matters Member must provide the Internal Revenue Service with information concerning the Members' identities, addresses, and profits interests as required under Code Section 6230(e). Notwithstanding the foregoing, the other Members shall be entitled to be present and to participate, at their own expense, in all such examinations, administrative and judicial proceedings. In addition, the Tax Matters Member shall consult in good faith with the other Members prior to entering into any extension of a statute of limitations, settlement agreement, or written filings or submissions in connection with an audit of the Company.

(d) The Tax Matters Member shall furnish to all Members with respect to the following—(i) all correspondence or written material received from or provided to from governmental taxing authorities, (ii) at least five business days advance notice of time, place, and subject of any meetings or conferences with federal, state, or local taxing authorities or any judicial proceedings, (iii) at last five business days advance notice of time, place, and subject of any closing conference with the examining agent; (iv) any proposed adjustments, rights of appeal, and requirements for filing of a protest, (v) at least five business days advance notice of time, place, and subject of any Appeals conference; (vi) acceptance by the Internal Revenue Service or other taxing authority of any settlement offer; (vii) consent to the extension of the period of limitations with respect to all Members; (viii) at least five business days advance notice of filing of a “request for administrative adjustment” (including a request for substituted return treatment under Treasury Regulations Section 301.6227(c)-1) on behalf of the Company; (ix) at least five days advance notice of filing by the Tax Matters Member of any petition for judicial review under Code Sections 6226 or 6228(a); (x) notice of filing by any other Member of any petition for judicial review under Code Sections 6226 or 6228(a); (xi) at least five business days advance notice of filing of any appeal with respect
to any judicial determination provided for in Code Sections 6226 or 6228(a); and (xii) any final judicial redetermination.

(e) Any Member may file a request for an administrative adjustment of “partnership items” for any Company taxable year at any time which is open under Code Section 6227(a). The Member shall provide a written copy of its “administrative adjustment request” to the Tax Matters Member at least 20 business days prior to filing with the Internal Revenue Service. The Tax Matters Member shall have the option of filing an “administrative adjustment request” on behalf of the Company with respect to such matters as shall be covered in the draft “administrative adjustment request” provided by the Member; in that event, the Member shall not file a separate “administrative adjustment request”.

(f) If any part of an “administrative adjustment request” filed by the Tax Matters Member under Code Section 6227(c) is not allowed by the Secretary of the Treasury, the Tax Matters Member may file a petition for an adjustment with respect to the “partnership items” to which such part of the request relates with—(A) the Tax Court, (B) the District Court of the United States for the district in which the principal place of business of the Company is located, or (C) the Claims Court. This petition shall be filed with respect to “partnership items” for a Company taxable year only—(i) after the expiration of 6 months from the date of filing of the request under Code Section 6227, and (ii) before the date which is 2 years after the date of such request. The Tax Matters Member may not file a petition for an adjustment with respect to the “partnership items” after the day the Secretary mails to the Company a notice of the beginning of an administrative proceeding with respect to the Company taxable year to which such request relates. No petition for an adjustment with respect to the “partnership items” may be filed after the Secretary of the Treasury mails to the Tax Matters Member a notice of “final partnership administrative adjustment” for the partnership taxable year to which the request under Code Section 6227 relates. If an action is brought by the Tax Matters Member under Code Section 6228(a)(1) with respect to any request for an adjustment of a partnership item for any taxable year—(i) each person who was a Member in the Company at any time during the Company taxable year involved shall be treated as a party to such action, and (ii) each such person shall be entitled to participate in the action. With respect to the Company, only the Tax Matters Member, a “notice partner”, or a 5-percent group may seek review of a determination by a court under Code Section 6228(a).

(g) Within 90 days after the day on which a notice of a “final partnership administrative adjustment” is mailed to the Tax Matters Mem-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ber, the Tax Matters Member may file a petition for a readjustment of the “partnership items” for such taxable year with—(1) the Tax Court, (2) the District Court of the United States for the district in which the partnership’s principal place of business is located, or (3) the Claims Court. If the Tax Matters Member does not file a readjustment petition, the immediately prior sentence with respect to any “final partnership administrative adjustment”, any “notice partner” (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in Code Section 6226(a), file a petition for a readjustment of the “partnership items” for the taxable year involved with any of the courts described in (1) the Tax Court, (2) the District Court of the United States for the district in which the partnership’s principal place of business is located, or (3) the Claims Court. If more than 1 action is brought by a Member for any partnership taxable year, the first such action brought in the Tax Court shall go forward. If more than 1 action is brought by a Member for any taxable year but no such action is brought in the Tax Court, the first such action brought shall go forward. The Tax Matters Member may intervene in any action brought by another Member. If an action is brought with respect to the Company for any partnership taxable year—(1) each person who was a Member at any time during such year shall be treated as a party to such action, and (2) each such person shall be entitled to participate in the action. Any Member treated as a party to an action shall be permitted to participate in such action (or file a readjustment petition) solely for the purpose of asserting that the period of limitations for assessing any tax attributable to “partnership items” has expired with respect to such person. No Member may file a readjustment petition under Code Section 6226(b) unless such Member would (after the application of Code Section 6226(d)(1)) be treated as a party to the proceeding. No Member shall have liability to post any deposit of tax in order to meet the jurisdictional requirements of Code Section 6226(e) for bringing action in District Court or Claims Court. With respect to the Company, only the Tax Matters Member, a “notice partner”, or a 5-percent group may seek review of a determination by a court under Code Section 6226. The Tax Matters Member shall have the authority to bind all Members of the Company to a settlement reflected in a Tax Court Decision.

(h) The Company shall indemnify and reimburse the Tax Matters Member for all reasonable expenses, including, without limitation, legal and accounting fees, claims, liabilities, losses and damages incurred in connection with any administrative or judicial proceeding with respect to the tax liability of the Members.

Some states – for example, California – do not have provisions for consolidated tax audits.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The tax matters partner must be a partner. 675

675 Section 6231(a)(7) provides:

(7) Tax matters partner. The tax matters partner of any partnership is—

(A) the general partner designated as the tax matters partner as provided in regulations, or

(B) if there is no general partner who has been so designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (or, where there is more than 1 such partner, the 1 of such partners whose name would appear first in an alphabetical listing).

If there is no general partner designated under subparagraph (A) and the Secretary determines that it is impracticable to apply subparagraph (B), the partner selected by the Secretary shall be treated as the tax matters partner. The Secretary shall, within 30 days of selecting a tax matters partner under the preceding sentence, notify all partners required to receive notice under section 6223(a) of the name and address of the person selected.

I.R.C. § 6231(a)(7). See also the rules of Treas. Reg. §§ 1.6231-1(a)(7)-1 ("(a) In general. A partnership may designate a partner as its tax matters partner for a specific taxable year only as provided in this section. Similarly, the designation of a partner as the tax matters partner for a specific taxable year may be terminated only as provided in this section. If a partnership does not designate a general partner as the tax matters partner for a specific taxable year, or if the designation is terminated without the partnership designating another general partner as the tax matters partner, the tax matters partner is the partner determined under this section. (b) Person who may be designated tax matters partner—(1) General requirement. A person may be designated as the tax matters partner of a partnership for a taxable year only if that person—(i) Was a general partner in the partnership at some time during the taxable year for which the designation is made; or (ii) Is a general partner in the partnership as of the time the designation is made. (2) Limitation on designation of tax matters partner who is not a United States person. If any United States person would be eligible under paragraph (a) of this section to be designated as the tax matters partner of a partnership for a taxable year, no person who is not a United States person may be designated as the tax matters partner of the partnership for that year without the consent of the Commissioner. For the definition of United States person, see section 7701(a)(30). (c) Designation of tax matters partner at time partnership return is filed. The partnership may designate a tax matters partner for a partnership taxable year on the partnership return for that taxable year in accordance with the instructions for that form. (d) Certification by current tax matters partner of selection of successor. If a partner proper- (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ly designated as the tax matters partner of a partnership for a partnership taxable year under this section certifies that another partner has been selected as the tax matters partner of the partnership for that taxable year, that other partner is thereby designated as the tax matters partner for that year. The current tax matters partner shall make the certification by filing with the service center with which the partnership return is filed a statement that—(1) Identifies the partnership, the partner filing the statement, and the successor tax matters partner by name, address, and taxpayer identification number; (2) Specifies the partnership taxable year to which the designation relates; (3) Declares that the partner filing the statement has been properly designated as the tax matters partner of the partnership for the partnership taxable year and that that designation is in effect immediately before the filing of the statement; (4) Certifies that the other named partner has been selected as the tax matters partner of the partnership for that taxable year in accordance with the partnership’s procedure for making that selection; and (5) Is signed by the partner filing the statement. (e) Designation by general partners with majority interest. The partnership may designate a tax matters partner for a partnership taxable year at any time after the filing of a partnership return for that taxable year by filing a statement with the service center with which the partnership return was filed. The statement shall—(1) Identify the partnership and the designated partner by name, address, and taxpayer identification number; (2) Specify the partnership taxable year to which the designation relates; (3) Declare that it is a designation of a tax matters partner for the taxable year specified; and (4) Be signed by persons who were general partners at the close of the year and were shown on the return for that year to hold more than 50 percent of the aggregate interest in partnership profits held by all general partners as of the close of that taxable year. For purposes of this paragraph (e)(4), all limited partnership interests held by general partners shall be included in determining the aggregate interest in partnership profits held by such general partners. . . .”}, 1.6231-1(a)(7)-2 (“(a) In general. Solely for purposes of applying section 6231(a)(7) and section 301.6231(a)(7)-1 to an LLC, only a member-manager of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner. (b) Definitions—… (3) Member-manager. Solely for purposes of this section, member-manager means a member of an LLC who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. Generally, an LLC statute may permit the LLC to choose management by one or more managers (whether or not members) or by all of the members. If there are no elected or designated member-managers (as so defined in this paragraph (b)(3)) of the LLC, each member will be treated as a member-manager for purposes of this section.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Not all partnerships are subject to TEFRA audit procedures. TEFRA audit procedures do not apply to “small partnerships” in the absence of election. These are “any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner.”\footnote{I.R.C. § 6231(a)(1)(B)(i).} These small partnerships can elect TEFRA treatment for any taxable year.\footnote{I.R.C. § 6231(a)(1)(B)(ii).}

The 10 or fewer limitation is applied to the number of natural persons, C corporations, and estates of deceased partners that were partners at any one time during the partnership taxable year. A partnership that at no time during the taxable year had more than 10 partners may be treated as a small partnership even if, because of transfers of interests in the partnership, 11 or more natural persons, C corporations, or estates of deceased partners owned interests in the partnership for some portion of the taxable year. The exception for small partnerships does not apply to a partnership for a taxable year if any partner in the partnership during that taxable year is a pass-thru partner. An estate is not treated as a pass-thru partner.

The determination of whether a partnership meets the small partnership exception is made with respect to each partnership taxable year. A partnership that does not qualify as a small partnership in one taxable year may qualify as a small partnership in another taxable year if the requirements for the small partnership exception are met with respect to that other taxable year.

Partnership agreements rarely succeed in setting ground rules for handling a TEFRA audit. Even otherwise superior partnership agreements usually fail to set forth comprehensive and sensible TEFRA audit provisions. A comprehensive TEFRA audit provision should address many issues, including:

- Tax matters partner qualifications,\footnote{For example, the tax matters partner must be a partner of the partnership, not merely an employee of the partnership, or a member or partner or officer of a constituent entity.} selection, indemnification, resignation, removal, replacement, compensation, and duties.
- The possibility that there may be different tax matters partners for different years.
- Ability of the tax matters partner to bind partners and the partnership.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- How to fund the partnership’s defense of the audit, particularly if the audit is instituted after the winding up and liquidation of the partnership.
- Conflicts of position and interest among partners.
- Consistency of partner and partnership reporting.
- Waivers of statutes of limitations.
- Waiver of TEFRA Rights by partners.
- Election of partnership into TEFRA status.
- Selecting or replacing counsel, and conflicts of interest that may arise.
- Cooperation of partners with partnership defense in IRS or state audit.
- Partner participation in audit proceedings.
- Sufficient document retention.
- Request for Administrative Adjustment of Partnership Items.
- Information Document Requests.
- IRS summons for documents and/or testimony.
- Notice of Proposed Audit Adjustment.
- Closing conference with IRS Examining Agent.
- Protest in response to 60-day Letter.
- Appeals Office conferences.
- Settlement agreement with IRS.
- Selection of forum for court litigation.
- Rules governing funding and undertaking of court litigation.


Specify which partner has the responsibility for preparing and filing partnership income tax returns. Some partnership agreements grant other partners the opportunity to review and comment on income tax returns before they are filed. They may establish a mechanism for resolving disputes among the partners over reporting tax items. In any event, facilitate timely filing of the partnership income tax return.
**Debt Maintenance Agreement.**

A contributor to a partnership often will have tax problems on account of liabilities in excess of basis. The contributor can face at risk recapture on account of his at risk amount becoming negative. These problems can be eliminated or mitigated if the contributing partner has a sufficient share of partnership indebtedness (in the case of at risk, indebtedness that provides an at risk amount to the contributing partner). No single model of debt maintenance agreement controls. Some debt maintenance agreements are designed to address liability relief issues under the partnership tax rules concerning liability relief. Other debt maintenance agreements are designed to address issues under the disguised sale rules – either with respect to pre-contribution debt or distributions from post-contribution debt. Debt maintenance agreements can address issues of at risk recapture under Section 465(e). These are some features that may be found in a debt maintenance agreement:

- Definition of the period of debt protection.
- Definition of a minimum debt maintenance amount (the minimum amount of debt to be made available to the partner). This often will be a number to permit the contributor to avoid Section 731 gain from liability relief.
- Covenant to make available to the partner a specified share of debt either through debt guarantees (often “bottom” guarantees) or through deficit restoration obligations. This often is a continuing covenant. The covenant often will provide characteristics of the debt and should address qualification under the at risk rules. Further, the covenant often will provide a minimum equity coverage and maximum percentage of the debt that will be guaranteed.
- Dealing with replacing the guaranteed debt if the guaranteed debt is repaid or otherwise goes away.
- Your partnership agreement should carefully explain how the “bottom” guarantee will operate.

---

679 See note 680.

680 With a typical “bottom” guarantee, assume that the total debt is 1,000 and that the partners have guaranteed the bottom 300 portion. If the debt does into default and the property is foreclosed on, there is no deficiency at all and no claim under the “bottom” guarantee if the property yields 1,000 at a foreclosure sale. There is a deficiency of 500, but no claim under the “bottom” guarantee if the property yields 500 at a foreclosure sale. There is a deficiency of 700, but no (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Frequently, there will be specified procedures if a single debt is to be guaranteed by multiple partners. The guarantee should clarify whether guarantor liability is joint and several or merely several.

- The lender often will be required to pursue all collateral if there is a default prior to seeking to collect on the guarantee and will be permitted to pursue the guarantee only if and to the extent that the lender collects less than the bottom guaranteed amount (after the realization on collateral).

- Procedure for replacement of debt if the debt is repaid or refinanced. Be careful. The replacement should be made before or concurrently with repayment of the old debt. The partner may recognize Section 731 gain if the replacement is made on a day after the repayment of the old debt.

- Possibly an annual renewal period for the guarantee. This is a touchy item. Any expiration and renewal provision should be drafted so that it does not vitiate the guarantee. A guarantor should not be permitted to terminate the guarantee on the eve of foreclosure by a creditor.

- A tax indemnification provision (parallel to the Section 704(c) tax indemnification) will apply if the debt maintenance covenant is violated by the partnership.

- The partnership may indemnify the partner who has guaranteed partnership debt. This indemnification can be material if partnership properties are encapsulated in single member limited liability companies or the liabilities otherwise are nonrecourse to the partnership. Otherwise, if the guarantee is called, the guarantor’s rights of subrogation may be worthless. 681

---

claim under the “bottom” guarantee if the property yields 300 at a foreclosure sale. There is a deficiency of 800 and a claim of 100 under the “bottom” guarantee if the property yields 200 at a foreclosure sale. The magic of the “bottom” guarantee is that the makers typically feel that the “bottom” guarantee is unlikely to be called. The “bottom” guarantees the first portion of the liability to be repaid. 681 Assume that the guarantee is called and that the guarantors will have to pay 200 under the guarantee. The guaranteeing partners will become subrogated to the rights of the creditor. Essentially, this means that the guarantors will have the rights previously held by the creditor. If the debt is nonrecourse indebtedness, there will be no subrogation rights. If the property is held in a single member limited liability company, the guarantors’ subrogation claims are limited to a claim (footnote continued on the next page)
Guarantees.

Partners often will enter “bottom” guarantees or other guarantees in order to avoid disguised sale gain or to avoid recognizing their negative capital accounts on account of liability relief. The “bottom” guarantee often should be a guarantee of payment and not a guarantee of performance. The guarantee often will require that the creditor must first resort to, and exhaust, all of rights its rights against the partnership and any collateral for the debt. The guarantee might require that the creditor proceed against the collateral by judicial foreclosure in jurisdictions that provide for foreclosure under a power of sale in a deed of trust. This could subject the creditor to equity of redemption. The guarantor often will reserve all guarantor defenses by statute or at common law. The guarantee may provide for cancellation by the guarantors. These provisions should be thought through carefully. The cancellation provisions should not render the guarantee a nullity.

Guarantees require some thought and should involve the participation of attorneys specializing in lending or commercial transactions. These are some observations on typical guarantees used to allocate partnership liabilities:

- The guarantee should be unconditional.
- The guarantee should clearly describe precisely what is guaranteed.
- There may be multiple guarantors. The guarantee should clearly allocate the monetary obligations of each guarantor.
- The guarantee should create several and not joint and several liability.
- A “bottom” guarantee should clearly state how it works.\(^ {682} \)
- The guarantee should be a guaranty of principal and not of interest.

against the single member limited liability company and its assets. The partnership itself may be able to walk away from the liability. For this reason, it becomes important for the guarantors also to have an indemnity agreement with the partnership under which the guarantors will have a claim for indemnity against the partnership if the guarantors are forced to make good on the guarantee.\(^ {682} \) The “bottom” guarantee typically involves this situation: the guarantors guarantee the bottom $x of a partnership debt and the creditor receives principal payments totaling $y (including amount realized on foreclosure). Each guarantor should have several liability for a proportionate share of any deficiency in principal payments to the extent that $x exceeds $y.
THE GUARANTEE SHOULD BE A GUARANTY OF COLLECTION AND SHOULD NOT BE A GUARANTEE OF THE BORROWER’S COVENANTS.

THE CREDITOR SHOULD BE REQUIRED, PRIOR TO MAKING ANY CLAIM AGAINST A GUARANTOR, TO RESORT TO, AND TO EXHAUST, ALL RIGHTS IT HAS AGAINST THE BORROWER IN A MANNER THAT SEeks TO MAXIMIZE THE RECOVERY OF THE GUARANTEED DEBT.

THESE ARE COMMON CONDITIONS TO A CLAIM AGAINST A GUARANTOR:

- All of the Collateral that secures the guaranteed debt has been sold pursuant to a judicial foreclosure sale; and
- A final order that is not subject to further appeal has been entered by a court of competent jurisdiction determining the amount of the deficiency in the guaranteed debt remaining after applying the greater of –
  - The proceeds of the foreclosure sale of all Collateral
  - The value of the Collateral as found by the court in connection with the final order,
  in either case, to reduce the amount of the guaranteed debt and to determine the deficiency.

THE GUARANTOR SHOULD RESERVE TO GUARANTORS ALL RIGHTS AND DEFENSES THAT CAN ACCRUE TO A SURETY AGAINST A PRINCIPAL, TO A GUARANTOR AGAINST A MAKER OR OBLIGOR, OR TO AN ACCOMMODATION PARTY AGAINST THE PARTY ACCOMMODATED OR TO A HOLDER OR TRANSFEE AGAINST A MAKER.

THE GUARANTOR SHOULD HAVE THE BENEFIT OF ALL RIGHTS AND DEFENSES LIMITING THE LIABILITY OF OR EXONERATING GUARANTORS OR SURETIES OFFERED BY LAW.

THE GUARANTEE SHOULD LIMIT THE GUARANTORS’ RIGHTS OF SUBROGATION, CONTRIBUTION AND REIMBURSEMENT SO THAT A GUARANTOR WILL NOT HAVE A CLAIM AGAINST ANOTHER PARTNER (INCLUDING A CLAIM ON ACCOUNT OF THE DEFICIT CAPITAL ACCOUNT OF ANOTHER PARTNER (PARTICULARLY A GENERAL PARTNER)).

THE TERM OF THE GUARANTEE SHOULD BE CLEAR. A GUARANTEE THAT CAN BE CANCELLED OR HAS EXPIRATION AND RENEWAL PROVISIONS SHOULD BE DRAFTED IN A MANNER SO THAT THE TERMS OF THE GUARANTEE DO NOT MAKE THE GUARANTEE EASILY AVOIDABLE AND A SHAM. THE GUARANTOR SHOULD NOT
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

be able to cancel his guarantee if the debt is in default or the borrower is in bankruptcy. Some advisors question whether guarantees can run for less than the term of the debt.\(^{683}\)

- The guarantor should not be able to avoid the guarantee by selling his interests in the partnership.

### 70. Organizational Expenses.

**Section x.x. Organizational Expenses.** The Partnership shall elect to deduct expenses (if any) incurred by it in organizing the Partnership ratably over a sixty month (60) period as provided in Section 709 of the Code.

Section 709 permits the partnership, if it so elects, to deduct organizational expenses ratably over a sixty-month period.

The tax law prohibits the immediate deduction of partnership organization and syndication costs and expenses. Syndication costs are permanently nondeductible. Organization expenses, on election, can be amortized over a sixty month period. Partnership organization and syndication expenses do not reduce the basis of a partner’s interest in the partnership. A partner who pays partnership organization or syndication expenses is not entitled to deduct these expenses immediately. Organization fees that were not previously deducted can be deducted as losses when the partnership liquidates.

Organizational expenses are expenses that:

- Are incident to the creation of the partnership;
- Are chargeable to capital account; and
- Are of a character that (if expended incident to the creation of a partnership having an ascertainable life) would (but for Section 709(a)) be amortized over this ascertainable life.\(^{684}\)

\(^{683}\) See, for example, Treas. Reg. § 1.707-5(a)(3) (“Reduction of partner’s share of liability. For purposes of this section, a partner’s share of a liability, immediately after a partnership assumes or takes subject to the liability, is determined by taking into account a subsequent reduction in the partner’s share if – (i) At the time that the partnership assumes or takes subject to a liability, it is anticipated that the transferring partner’s share of the liability will be subsequently reduced; and (ii) The reduction of the partner’s share of the liability is part of a plan that has as one of its principal purposes minimizing the extent to which the assumption of or taking subject to the liability is treated as part of a sale under section 1.707-3.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

An expenditure that fails to meet one or more of these three filters does not qualify as an organizational expense. An organizational expense must be incurred during the period beginning at a point that is a reasonable time before the partnership begins business and ending with the date prescribed by law for filing the partnership return (determined without regard to any extensions of time) for the taxable year the partnership begins business. Organizational expenses must be for creation of the partnership and not for operation or starting operation of the partnership trade or business. An organizational expense must be for an item of a nature normally expected to benefit the partnership throughout the entire life of the partnership. These are organizational expenses:

- Legal fees for services incident to the organization of the partnership (for example, negotiation and preparation of a partnership agreement).
- Accounting fees for services incident to the organization of the partnership; and filing fees.

These expenses are not amortizable organizational expenses:

- Expenses connected with acquiring assets for the partnership or transferring assets to the partnership.
- Expenses connected with the admission or removal of partners other than at the time the partnership is first organized.
- Expenses connected with a contract relating to the operation of the partnership trade or business (even when the contract is between the partnership and one of its members).
- Syndication expenses.

---

684 I.R.C. § 709(b)(3); Treas. Reg. § 1.709-2(a).
685 Treas. Reg. § 1.709-2(a).
687 Syndication expenses are expenses connected with the issuing and marketing of interests in the partnership. These are examples of nondeductible syndication expenses:
- Brokerage fees.
- Registration fees.
- Legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes.

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

71. Member Loans.

Section x.x. Member Loans. Notwithstanding Section y.y, the Company may obtain from one or more Members, a financial institution or other sources one or more loans to the Company to fund all or part of the required funds when the Company needs funds for Capital Improvements or to fund an Operating Deficit. Any loan shall bear interest at the rate, be secured in the manner and be repayable on the terms as the Manager may determine. The immediately previous sentence is qualified by the requirement that, if any loan is from a Member or an Affiliate of a Member, then it either (i) shall be approved by the Members, or (ii) shall be made on reasonable commercial terms (including (without prejudice to generality) commercially reasonable interest). Any loans shall be evidenced by a written promissory note (approved in form and substance by the Manager).

This is another provision that addresses partner loans:

Section x.x. Failure to Make Required Contribution. When a Member (a “Defaulting Member”) fails to contribute in a timely manner its full share of any Capital Contribution, that failure shall constitute a Default under this Agreement. The remedies set forth at Section y.y shall be available to the Company and the other Members. In this event, all other Members may fund (but shall not be obligated to fund) all or any portion of the Defaulting Member’s shortfall (in each case, a “Delinquency Contribution”) in proportion to their Percentage Interests or as they may otherwise agree among themselves. The right to fund the Delinquency Contribution is in addition to any other rights those other Members of the Company may have under this Agreement. Each Member electing to do fund this contribution is referred to as a “Contributing Member.” One or more Members may elect (upon Approval by the Members) to advance (a “Member Loan”) all or any portion of the shortfall to the Company. These advances shall be made in proportion to their Percentage Interests or (as they may otherwise agree among themselves). These advances shall be made with recourse only to the assets of the Company and not to the assets of the Defaulting Member or any other Member. All Member Loans made to the Company by the Members under this Section x.x shall bear interest

- Accounting fees for preparation of representations to be included in the offering materials.
- Printing costs of the prospectus, placement memorandum, and other selling and promotional material.

Treas. Reg. § 1.709-2(b).
at the rate of X% per annum. Interest shall be compounded daily. Interest shall be computed on the basis of a computational year of 360 days and 30-day months. Those Member Loans shall be payable to the lending Members prior to any Distributions being made to any Members under Section 2.2, with repayments being applied first to reduce any interest accrued thereon and then to reduce principal.

Another provision permits emergency loans:

Section 3.x. Emergency Loans. Any Member may make (upon approval by the Manager) one or more loans to the Company (each, an “Emergency Loan”) if the Manager believes (in its sole and absolute opinion) that (i) the Company lacks funds to respond to an Emergency and (ii) insufficient time is available for the Company to acquire the necessary funds through the Additional Contribution procedures specified above. The authorization of an Emergency Loan is subject to the satisfaction of these conditions:

(a) The Manager shall give each other Member prompt written notice of each Emergency Loan following the making thereof.

(b) Each Emergency Loan shall be outstanding for a period not exceeding ninety (90) days to the extent practicable given the cash resources of the Company.

(c) The maximum outstanding principal amount of any Emergency Loan at any time shall not exceed Two Hundred Fifty Thousand Dollars ($250,000).

(d) The maximum aggregate outstanding principal amount of all Emergency Loans at any one time shall not exceed Five Hundred Thousand Dollars ($500,000).

Any Emergency Loans made to the Company by the Members under this Section 3.x shall bear interest at the rate of X% per annum. Interest shall be compounded daily. Interest shall be computed on the basis of a computational year of 360 days and 30-day months. Those Emergency Loans shall be payable to the lending Members prior to any Distributions being made to any Members under Section 2.2, with repayments being applied first to reduce any interest accrued thereon and then to reduce principal. All principal and interest on all outstanding Emergency Loans shall be an expense of the Company.

Partnership agreements often contain provisions that permit or require partners to make loans to your partnership when it needs cash. Specify when these loans are to be made, who calls from them, who is permitted or required to make the loans, how they are evidenced, whether they are secured, whether they are re-
course, all economic terms of the loan (including interest, term, and payment terms), and priority of loans by comparison to cash distributions to partners.

72. Service Partners.

Consider special drafting for a partnership that admits one or more partners as consideration for the performance of services. Proposed Treasury Regulations and a revenue procedure set forth a bouquet of rules concerning service partner rules. These rules will subject your partnership to special recordkeeping requirements. This Article contains only a brief, introductory consideration of the rules governing the admission of service partners. There currently are many unresolved issues and many difficult drafting problems. Many of these issues create profound problems for you as a draftsman of partnership agreements. Be particularly sensitive to the affects of changing tax rules regarding the admission of service partners on capital accounts. The bar will have to develop methods of dealing with the many capital account issues that are created by partners who receive partnership interests on account of the performance of services.

688 See materials cited in note 693 on service partners.

689 As this is being drafted, Congress is considering H.R. 2834 (introduced by Representative Levin) that would characterize the distributive share of certain service partners automatically as ordinary income. This treatment would apply to any “investment services partnership.” Under the bill,

The term “investment services partnership interest” means any interest in a partnership which is held by any person if such person provides (directly or indirectly), in the active conduct of a trade or business, a substantial quantity of any of the following services to the partnership:

(A) Advising the partnership as to the value of any specified asset.

(B) Advising the partnership as to the advisability of investing in, purchasing, or selling any specified asset.

(C) Managing, acquiring, or disposing of any specified asset.

(D) Arranging financing with respect to acquiring specified assets.

(E) Any activity in support of any service described in subparagraphs (A) through (D). For purposes of this paragraph, the term “specified asset” means securities (as defined in section 475(c)(2) without regard to the last sentence thereof), real estate, commodities (as defined in section 475(e)(2)), or options or derivative contracts with respect to securities (as so defined), real estate, or commodities (as so defined).

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The tax law was roiled by the publication of proposed but not yet [at the
time when this Article was written] finalized Treasury Regulations governing the
taxability of service partners.690 These Proposed Treasury Regulations apply only
to a transfer by a partnership of an interest in that partnership in connection with
the performance of services for that partnership (compensatory partnership inter-
ests). Partnership case law, statutory law and administrative law are even more
unclear when the service partner receives a partnership interest in one partnership
as consideration for the performance of services for another partnership or another
person. The Proposed Treasury Regulations do not address the income tax conse-
quences of the transfer of an interest in a lower-tier partnership in exchange for
services provided to the upper-tier partnership. The Proposed Treasury Regu-
lations currently appear to be languishing in tax law purgatory, neither finalized,
nor amended, nor revoked, nor applied by the Internal Revenue Service.

The IRS has not formally expressed a view on the status of partnership ar-
rangements under Section 409A at the time when this Article is written.691 Unless
certain requirements are met, amounts deferred under a nonqualified deferred
compensation plan are currently includible in gross income to the extent not sub-
ject to a “substantial risk of forfeiture” and not previously included in gross in-
come.692

The bill generally provides that “any net income with respect to such interest
for any partnership taxable year shall be treated as ordinary income for the per-
formance of services.” The rules are considerably more complex than this, but this
should give you a general sense of the direction of the bill in its current form.

Note that these regulations are proposed but not finalized. The final rules
may change substantially from the proposed rules discussed in this Article.
Section 409A was added to the Internal Revenue Code by Section 885 of

The preamble to Section 409A Proposed Treasury Regulations states:

The statute and legislative history to section 409A do not specifically
address arrangements between partnerships and partners providing ser-
vices to a partnership, and do not explicitly exclude such arrangements
from the application of section 409A. The application of section 409A to
such arrangements raises a number of issues, relating both to the scope of
the arrangements subject to section 409A, and the coordination of the
provisions of subchapter K and section 409A with respect to those ar-
rangements that are subject to section 409A. The Treasury Department
and the IRS continue to analyze the issues raised in this area, and accord-
ingly these regulations do not address arrangements between partnerships
and partners. Notice 2005-1, Q&A-7 provides interim guidance regarding
(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Many unresolved problems concerning partnership interests and partnership options and Section 409A linger. These problems are beyond the scope of this Article.693 Those problems appear to be indefinitely deferred until (if ever)

the application of section 409A to arrangements between partnerships and partners. Until further guidance is issued, taxpayers may continue to rely on Notice 2005-1, Q&A-7.

Commentators have asked whether section 409A applies to guaranteed payments for services described in section 707(c). Until further guidance is issued, section 409A will apply to guaranteed payments described in section 707(c) (and rights to receive such guaranteed payments in the future), only in cases where the guaranteed payment is for services and the partner providing services does not include the payment in income by the 15th day of the third month following the end of the taxable year of the partner in which the partner obtained a legally binding right to the guaranteed payment or, if later, the taxable year in which the right to the guaranteed payment is first no longer subject to a substantial risk of forfeiture.


693 See, for example, letter from Michael D. Stuart, Vinson & Elkins, LLP, dated October 26, 2006, to Internal Revenue Service, Attn: Stephen Tackney and Daniel Hogans, Re: Comments of the National Association of Publicly Traded Partnerships on the Proposed Regulations Regarding the Application of Section 409A to Unit Option and Unit Appreciation Rights, 2006 TNT 213-17 (October 26, 2006); letter from Dennis B. Drapkin, Chair, Section of Taxation, American Bar Association, and Susan P. Serota, Chair-Elect, Section of Taxation, American Bar Association, dated July 31, 2006, to the Honorable William M. Thomas, Chairman, House Committee on Ways and Means, the Honorable Charles E. Grassley, Chairman, Senate Committee on Finance, the Honorable Charles B. Rangel, Ranking Member, House Committee on Ways and Means, the Honorable Max S. Baucus, Ranking Member, Senate Committee on Finance, Re: I.R.C. Section 409A, 2006 TNT 147-23 (July 31, 2006); letter from Dennis B. Drapkin, Chair, Section of Taxation, American Bar Association, dated November 1, 2005, to Hon. Mark W. Everson, Commissioner, Internal Revenue Service, Re: Comments on Proposed Treasury Regulations Under Section 409A, 2005 TNT 212-18 (November 1, 2005); letter from Kenneth W. Gideon, Chair, Section of Taxation, dated May 20, 2005, to the Honorable Mark W. Everson, Commissioner of Internal Revenue, Re: Comments on the Transition Rule and Effective Date Under Section 409A, 2005 TNT 103-54 (May 20, 2005); letter from David P. Hariton, Chair, New York State Bar Association Section on Taxation, dated October 26, 2005, to Mr. Eric Solomon, Acting Deputy Assistant Secretary (Tax (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Policy), and the Honorable Mark W. Everson, Commissioner, Internal Revenue Service, Re: Partnership Equity Received in Exchange for Services 2005 TNT 214-19 (October 26, 2005). On Section 83 and partnerships, see Cowan, “Receipt of an Interest in Partnership Profits: The Diamond Case,” 26 TAX L. REV. 161 (1972); Richard Lipton, “Proposed Regs, Rev. Proc. on Transfers of Partnership Equity Interests for Services: Did the IRS Get It Right?”, 109 TAX NOTES 791 (Nov. 7, 2005); Sheldon I. Banoff, “Partnership Use of Corporate Partner Stock and Options and Compensation Easier Under the 1032 Regs,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Sheldon I. Banoff and Eric B. Sloan, “Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests – The Final Facet of Diamond?,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Sheldon I. Banoff, “First IRS Ruling on Unvested Partnership Interests Issued For Services: Practical Problems and Opportunities” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Linda Z. Swartz, “Section 83(b), Section 409(A) and Subchapter K,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Eric B. Sloan, “Proposed Partnership Equity Compensation Regulations: ‘Little or no Chance’ of Satisfying Everyone” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Blake D. Rubin & Andrea Macintosh Whiteway, “Proposed Regulations on Partnership Interests Issued For Services: Practical Problems and Opportunities” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; William P. Bowers, Chair, Section of Taxation, State Bar of Texas, letter to Eric Solomon, Acting Deputy Assistant Secretary (Tax Policy), Department of the Treasury, and the Honorable Mark W. Everson, Commissioner, Internal Revenue Service, Re: REG-105346-03, 2005 TNT 168-12 (August 22, 2005); Andrew N. Berg, Chair, New York State Bar Association Section on Taxation, letter to the Honorable Pamela F. Olson, Assistant Secretary (Tax Policy), and the Honorable Mark W. Everson, Commissioner, Internal Revenue Service, 2004 TNT 16-81 (January 23, 2004); New York State Bar Association Tax Section Report No. 1005, “Report on the Taxation of Partnership Options and Convertible Securities,” 2002 TNT 21-24 (January 29, 2002); New York State Bar Association Tax Section Report No.

(footnote continued on the next page)
Treasury Regulations are published on partnership interests and partnership options under Section 409A.

Notice 2006-79 provides transition relief under Section 409A. This notice announces that the final regulations will not become effective until January 1, 2008; generally extends through 2007 the transition relief provided for 2006 in the preamble to the Proposed Treasury Regulations except with respect to certain discounted stock rights; provides additional transition relief for certain payment elections in linked plans and certain collective bargaining arrangements; and extends the amendment date for certain plans that took advantage of transition relief provided for 2005.

The Proposed Treasury Regulations under Section 83 create challenges to address in drafting your partnership agreement. Consider including in your partnership agreement the liquidation-of-the-partnership valuation election provided for in the Proposed Treasury Regulations. Consider the effects of the admission of a service partner to your partnership and the effects on capital accounts. The Proposed Treasury Regulations provide for a positive adjustment to the capital account of the service partner who recognizes income on account of his admission to the partnership, even though the service partner purports to be a profits interest partner. This adjustment to capital accounts (and the corresponding reduction in partners’ capital accounts on account of the concomitant deductions) will affect partnership economics.


A substantial body of literature considers the tax effects of receiving or granting a partnership interest (particularly a profits interest) as consideration for the performance of services. The receipt of a partnership interest as consideration for the performance of services is potentially taxable to the service partner. Proposed Treasury Regulations recently roiled the waters by concluding that the receipt of a profits interest in a partnership in consideration of the performance of services is taxable to the service partner (for example, an associate who is admitted as a partner to a law firm partnership, or a real estate promoter who receives a “carried” interest in a partnership). These Treasury Regulations are merely proposed and not final and binding on taxpayers or the IRS. These Treasury Regulations provide insight into the IRS’ current thinking.

Proposed Treasury Regulations permit the service partner’s income to be measured under a safe harbor based on the amount that the service partner would receive if your partnership sold its assets and immediately liquidated (at the time of the service partner’s admission). This safe harbor says that the measure of the service partner’s income is the amount that the service partner would receive in the liquidation. The fair market value of the service partner’s interest is treated as being equal to the liquidation value of that interest when a liquidation-of-the-partnership valuation election is made. Liquidation value is determined without regard to any lapse restriction. “Liquidation value” means the amount of cash that the service partner would receive if (immediately after the transfer) the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership’s operations) for cash equal to the fair market value of those assets and then liquidated.

Consider including a provision in your partnership agreement that is legally binding on all of the partners stating that: (i) your partnership is authorized and

---

695 See materials cited in notes 823 and 693.
699 Prop. Treas. Reg. § 1.83-3(l); Notice 2005-43, 2005-24 I.R.B. 1221 (“.02 Liquidation Value. Under the Safe Harbor, the fair market value of a Safe Harbor Partnership Interest is treated as being equal to the liquidation value of that interest. For this purpose, liquidation value is determined without regard to any lapse restriction (as defined at § 1.83-3(i)) and means the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership’s operations) for cash equal to the fair market value of those assets and then liquidated.”).
directed to elect the safe harbor; and (ii) your partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agree to comply with all of the requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the liquidation-of-the-partnership valuation election remains effective. Consider addressing this election (even before Treasury Regulations are finalized). Address the liquidation-of-the-partnership valuation election at the initial drafting stage rather than seek later to repair your partnership agreement by amendment.  

701 The Proposed Treasury Regulations provide:

(1) Special rules for the transfer of a partnership interest. (1) Subject to such additional conditions, rules, and procedures that the Commissioner may prescribe in regulations, revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(b) of this chapter), a partnership and all of its partners may elect a safe harbor under which the fair market value of a partnership interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that interest for transfers on or after the date final regulations are published in the Federal Register if the following conditions are satisfied:

(i) The partnership must prepare a document, executed by a partner who has responsibility for Federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor apply irrevocably as of the stated effective date with respect to all partnership interests transferred in connection with the performance of services while the safe harbor election remains in effect and attach the document to the tax return for the taxable year that includes the effective date of the election.

(ii) Except as provided in paragraph (l)(1)(ii) of this section, the partnership agreement must contain provisions that are legally binding on all of the partners stating that—

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in

(footnote continued on the next page)
The IRS has adopted the view that the partnership is not taxable on its transfer of a compensatory partnership interest to a service partner. The basis of partnership assets is not affected by the admission of a service partner (except to the extent that the compensation deduction is capitalized in the basis of partnership assets).

The measure of the service partner’s income outside of the safe harbor may be based on the excess of the fair market value of the partnership interest over any amount that the partner may pay for that interest. This potentially can apply in situations in which the service partner contributes both cash and services as consideration for the partner’s interest in your partnership. Many partnerships involve mixed contributions of cash and services. The liquidation-of-the-partnership valuation election of liquidation valuation in your partnership agreement then is particularly important. This election should be important whenever a partner contributes services to a partnership (at least it will be important if the Proposed Treasury Regulations are finalized as they now are drafted). 702

Many considerations of the taxation of the receipt of a partnership interest for services have not been resolved at the time when this Article is written. Some of the issues are discussed in Proposed Treasury Regulations issued by Treasury. 703 There long has been a controversy concerning the tax effects of the admission of a partner as consideration for services performed for the partnership. The

connection with the performance of services while the election remains effective.

(iii) If the partnership agreement does not contain the provisions described in paragraph (l)(1)(ii) of this section, or the provisions are not legally binding on all of the partners of the partnership, then each partner in a partnership that transfers a partnership interest in connection with the performance of services must execute a document containing provisions that are legally binding on that partner stating that –

(A) The partnership is authorized and directed to elect the safe harbor; and

(B) The partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the election remains effective.


Law firm partnerships and accounting firm partnerships are particularly well-advised to consider making the election to value the service partner’s interest using a liquidation analysis. 703 REG-105346-03, 70 Fed. Reg. 29675-29683.
laws concerning the issuance of corporate stock as consideration for services are much better defined. Section 83 taxes the service partner when the stock becomes substantially vested. The corporation is entitled to a corresponding deduction, unless the nature of the services forces the corporation to capitalize the payment. The Proposed Treasury Regulations conclude that Section 83 applies when a capital or profits interest in a partnership is issued in consideration of the performance of services for the partnership. This subjects this transaction to taxation under rules that have become fairly well defined when other forms of property (including stock in a corporation) are transferred in consideration of the performance of services. Many partnership draftsmen had hoped that the transfer of a profits interest in a partnership (whatever that is) would not be taxable under the Section 83 regime. There had been a 15-year informal truce between taxpayers and the government from the publication of the 8th Circuit’s opinion in *Campbell v. Commissioner*,704 under which the IRS appeared willing to accept the nontaxability of the recipients of profits interests in partnerships under the questionable theory that the profits interest had no immediate value on the date of transfer.705 The Proposed Treasury Regulations repudiate this truce and this theory.

The Proposed Treasury Regulations treat partnership interests issued to service partners for services rendered to the partnership as guaranteed payments.706 Section 83 timing rules override the timing rules of Section 706(a) and Treasury Regulations Section 1.707-1(c). The timing and the amount of the related income inclusion and deduction is determined by Section 83. The service partner includes the transfer in income for the taxable year in which the transfer occurs (rather than the taxable year in which or with which ends the partnership taxable year in which the transfer occurs). Partnership deductions that are attributable to the portion of the partnership’s taxable year prior to a new partner’s entry into the partnership are allocated to the historic partners.

---

704 T.C. Memo 1990-162, aff’d in part and rev’d in part, 943 F.2d 815 (8th Cir. 1991).


706 Prop. Treas. Reg. § 1.721-1(b)(4) (“To the extent that a partnership interest is – (i) Transferred to a partner in connection with the performance of services rendered to the partnership, it is a guaranteed payment for services under section 707(c); (ii) Transferred in connection with the performance of services rendered to a partner, it is not deductible by the partnership, but is deductible only by such partner to the extent allowable under Chapter 1 of the Code.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The Proposed Treasury Regulations adopt the theory that a partnership interest transferred as consideration for services is subject to the Section 83 regime and is taxable. This regime delays the taxability of a restricted partnership interest until that restricted partnership interest either is transferable or is not subject to a “substantial risk of forfeiture.” Section 83(b) permits the partner to elect to ignore the fact that his partnership interest is restricted and to be taxable upon the grant of his partnership interest. The service partner will include in income the excess of —

- The fair market value of the partnership interest (at the time of transfer) (determined without regard to a restriction other than a restriction that by its terms will never lapse); _over_
- The amount paid for the partnership interest.

This Section 83(b) election must be made within 30 days of the date of the transfer of the property to the service partner.

The service partner is not treated as a partner at all until his partnership interests is treated as vested if he receives a restricted partnership interest and fails to make a Section 83(b) election. Payments that he receives from the partnership prior to the vesting of the partnership interest are generally treated as salary or as payments to an independent contractor. The restricted service partner does not receive a distributive share of the partnership’s income or loss prior to vesting of his partnership interest. The service partner, however, will be treated as a partner from the grant of the restricted partnership interest if he properly makes a Section 83(b) election.

---

708 I.R.C. § 83(b)(2).
709 Some partnership agreement provide that no distributions are made to partners who hold unvested interests; distributions commence when the partnership interests vest. Some partnership agreements only make tax distributions to these partners until the interests vest. The IRS may not consider these profits interests to have been issued until they vest (notwithstanding an I.R.C. § 83(b) election). The result may be to vitiate an I.R.C. § 83(b) election, since that election can be made only if the partnership interest has been transferred to the service partner.
710 Prop. Treas. Reg. § 1.704-1(b)(4)(xii) (“Substantially nonvested interests – (a) In general. If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will lat- (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The IRS published Revenue Procedure 2001-43 in 2001.\textsuperscript{711} This Revenue Procedure provided that, under its conditions,\textsuperscript{712} if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no Section 83(b) election is made. Many advisors advise still advice making a Section 83(b) election. A service partner may transfer his partnership interest within two years of receipt. This transfer disqualifies the partnership interest from the benefit of Revenue Procedure 2001-43.

Revenue Procedure 93-27\textsuperscript{713} previously had provided that a partner who receives a profits interest in a partnership is not taxable at all. That revenue procedure provided that: “A capital interest is an interest that would give the holder a share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest.” Any interest in liquidation proceeds apparently makes a partnership interest a capital interest. By way of contrast, “[a] profits interest is a partnership interest other than a capital interest.” The revenue procedure established the general principle that the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation to the service partner. The revenue procedure provided that, with three exceptions, “if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the Internal Revenue Service may treat the person as having received the profits interest at the time the interest is substantially vested.”

\textsuperscript{711} 2001-2 C.B. 191.

\textsuperscript{712} Revenue Procedure 2001-43, 2001-2 C.B. 191, provides: “This revenue procedure clarifies that, for purposes of Rev. Proc. 93-27, where a partnership grants an interest in the partnership that is substantially nonvested to a service provider, the service provider will be treated as receiving the interest on the date of its grant, provided that: .01 The partnership and the service provider treat the service provider as the owner of the partnership interest from the date of its grant and the service provider takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the service provider’s income tax liability for the entire period during which the service provider has the interest; .02 Upon the grant of the interest or at the time that the interest becomes substantially vested, neither the partnership nor any of the partners deducts any amount (as wages, compensation, or otherwise) for the fair market value of the interest; and .03 All other conditions of Rev. Proc. 93-27 are satisfied.”

\textsuperscript{713} 1993-2 C.B. 343.
Revenue Service will not treat the receipt of such an interest as a taxable event for the partner or the partnership.” The IRS would not seek to tax the service partner if the service partner would not receive any liquidation proceeds if the partnership liquidated on the date of his admission.

Revenue Procedure 93-27 established three exclusions where its rules (concerning liquidation-methodology for determining the value of the service partner’s partnership interest) do not apply:

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets;714
- Within two years of receipt, the partner disposes of the profits interest; or
- The profits interest is a limited partnership interest in a “publicly traded partnership” within the meaning of Section 7704(b) of the Internal Revenue Code.

Consider whether the service partner’s interest may fall into one of these three categories. The partnership interest will be valued under normal valuation rules (willing buyer—willing seller) rather than liquidation-of-the-partnership valuation rules.

The Proposed Treasury Regulations:

- Contain timing of income and deduction rules conforming the partnership rules to the Section 83 timing rules;
- Revise the capital account maintenance requirement of the Section 704(b) Treasury Regulations to consider the fact that allocations with respect to an unvested interest may be forfeited; and
- Provide that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership.

The IRS issued Notice 2005-43.715 That Notice contains a proposed revenue procedure that, when finalized, values the transferred service partner’s partnership interest based on a liquidation value if the revenue procedure’s requirements are met. The proposed revenue procedure would set forth an elective safe harbor. The safe harbor contains rules concerning election, consistent reporting,

---

714 For example, income from high-quality debt securities or a high-quality net lease.
and recordkeeping. Each of these rules will challenge you in drafting your partnership agreement.\footnote{If the safe harbor valuations method is elected, Under the Safe Harbor, the fair market value of a Safe Harbor Partnership Interest is treated as being equal to the liquidation value of that interest. For this purpose, liquidation value is determined without regard to any lapse restriction (as defined at § 1.83-3(i)) and means the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership’s operations) for cash equal to the fair market value of those assets and then liquidated. “The partnership interest “is treated as substantially vested if the right to the associated capital account balance equivalent is not subject to a substantial risk of forfeiture or the interest is transferable. A Safe Harbor Partnership Interest is treated as substantially nonvested only if, under the terms of the interest at the time of the transfer, the interest terminates and the holder may be required to forfeit the capital account balance equivalent credited to the holder under conditions that would constitute a substantial risk of forfeiture, and the interest is not transferable. For these purposes, the capital account balance equivalent is the amount of cash that the recipient of the Safe Harbor Partnership Interest would receive if, immediately prior to the forfeiture, the interest vested and the partnership sold all of its assets (including goodwill, going concern value, or any other intangibles associated with the partnership’s operations) for cash equal to the fair market value of those assets and then liquidated. Notwithstanding the previous sentence, a Safe Harbor Partnership Interest will not be considered substantially nonvested if the sole portion of the capital account balance equivalent forfeited is the excess of the capital account balance equivalent at the date of termination of services over the capital account balance equivalent at the end of the prior partnership tax year or any later date before the date of termination of services. Notice 2005-43, 2005-24 I.R.B. 1221.}
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- The value of the partnership interest, \( over \)
- Any amount paid for the partnership interest.

The service partner may receive a service partnership interest that is substantially nonvested (subject to a “substantial risk of forfeiture”). He may not make an election under Section 83(b), and may hold the partnership interest until it substantially vests. The service partner then recognizes compensation income in an amount equal to the excess of —

- The value of the partnership interest on the date the partnership interest substantially vests,\(^{717}\) \( over \)
- Any amount paid for the partnership interest.

The service partner may receive a service partnership interest that is substantially nonvested and makes an election under Section 83(b). The service partner recognizes compensation income on the date of transfer equal to the excess of —

- The liquidation value of the partnership interest, determined as if the partnership interest were substantially vested, \( over \)
- Any amount paid for the partnership interest.

The partnership generally is entitled to a deduction equal to the amount included as compensation in the gross income of the service partner under Section 83, but only to the extent that the amount otherwise meets the requirements for deductibility of Section 162 or Section 212.

The revenue procedure imposes special rules if a Section 83(b) election has been made with respect to a restricted partnership interest and the restricted interest is later forfeited. The service partner must include as ordinary income in the taxable year of the forfeiture an amount equal to the excess (if any) of —

- The amount of income or gain that the partnership would be required to allocate to the service partner\(^{718}\) if the partnership had unlimited items of gross income and gain, \( over \)
- The amount of income or gain that the partnership actually allocated to the service partner under Proposed Treasury Regulations Section 1.704-1(b)(4)(xii).

A partnership interest subject to the valuation election that will qualify for this election and this special treatment is any interest in a partnership that is trans-

\(^{717}\) Determined without regard to a restriction other than a restriction which by its terms will never lapse.

\(^{718}\) Treas. Reg. § 1.704-1(b)(4)(xii).
ferred to a service partner by the partnership in connection with services provided to the partnership (either before or after the formation of the partnership), if the partnership interest is not —

- Related to a substantially certain and predictable stream of income from partnership assets (for example, income from high-quality debt securities or a high-quality net lease),
- Transferred in anticipation of a subsequent disposition, or
- An interest in a publicly traded partnership within the meaning of Section 7704(b).\(^{719}\)

A partnership interest is presumed to be transferred in anticipation of a subsequent disposition if the partnership interest —

\(^{719}\) Notice 2005-43, 2005-24 I.R.B. 1221, provides:

.02 Safe Harbor Partnership Interest. (1) Except as otherwise provided in section 3.02(2) of this revenue procedure, a Safe Harbor Partnership Interest is any interest in a partnership that is transferred to a service provider by such partnership in connection with services provided to the partnership (either before or after the formation of the partnership), provided that the interest is not (a) related to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease, (b) transferred in anticipation of a subsequent disposition, or (c) an interest in a publicly traded partnership within the meaning of § 7704(b). Unless it is established by clear and convincing evidence that the partnership interest was not transferred in anticipation of a subsequent disposition, a partnership interest is presumed to be transferred in anticipation of a subsequent disposition for purposes of the preceding clause (b) if the partnership interest is sold or disposed of within two years of the date of receipt of the partnership interest (other than a sale or disposition by reason of death or disability of the service provider) or is the subject, at any time within two years of the date of receipt, of a right to buy or sell regardless of when the right is exercisable (other than a right to buy or sell arising by reason of the death or disability of the service provider). For the purposes of this revenue procedure, “disability” means a condition which causes a service provider to be unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment expected to result in death or to last for a continuous period of not less than 12 months.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Is sold or disposed of within two years of the date of receipt of the partnership interest,\(^{720}\) or
- Is the subject (at any time within two years of the date of receipt) of a right to buy or sell regardless of when the right is exercisable.\(^{721}\)

“Disability” means a condition that causes a service partner to be unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment expected to result in death or to last for a continuous period of not less than 12 months.\(^ {722}\) The precise meaning of “unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment” is unresolved.

The election requires that your partnership satisfy these conditions in order to use the liquidation-of-the-partnership valuation methodology in valuing the partnership interest of the service partner:

- Your partnership must prepare a document, executed by a partner who has responsibility for federal income tax reporting by the partnership, stating that the partnership is electing, on behalf of the partnership and each of its partners, to have the safe harbor described in Rev. Proc. 200x-xx apply irrevocably with respect to all partnership interests transferred in connection with the performance of services while the valuation election remains in effect. This document must specify the effective date of the valuation election. The effective date may not be prior to the date that the valuation election is executed. The liquidation-of-the-partnership valuation election must be attached to the tax return for the partnership for the taxable year that includes the effective date of the valuation election.

- Your partnership agreement must contain provisions that are legally binding on all of the partners stating that (a) your partnership is authorized and directed to elect the safe harbor, and (b) your partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the

\(^{720}\) Other than a sale or disposition by reason of death or disability of the service partner.

\(^{721}\) Other than a right to buy or sell arising by reason of the death or disability of the service partner.

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

safe harbor with respect to all partnership interests transferred in connection with the performance of services while the liquidation-of-the-partnership valuation election remains effective. A partner that is bound by these provisions transfers a partnership interest to another person. The requirement that each partner be bound by these provisions is satisfied only if the person to whom your partnership interest is transferred assumes the transferring partner’s obligations under your partnership agreement. If an amendment to your partnership agreement is required, the amendment must be effective before the date when a transfer occurs for the safe harbor to be applied to the transfer.

- Your partnership agreement may not contain the provisions described in the immediately preceding paragraph, or the provisions may not legally bind all of the partners of your partnership. Each partner that transfers a partnership interest in connection with the performance of services then must execute a document containing provisions that are legally binding on each partner stating that (a) your partnership is authorized and directed to elect the safe harbor, and (b) the partner agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the liquidation-of-the-partnership valuation election remains effective. Each person classified as a partner must execute this document. The document must be effective, before the date when a transfer occurs, for the safe harbor to be applied to the transfer. If a partner who has submitted the required document transfers a partnership interest to another person, the condition that each partner submit the necessary document is satisfied only if the person to whom the partnership interest is transferred either submits the required document or assumes the transferring partner’s obligations under this document that was previously submitted with respect to the transferred interest.

These requirements have not yet been tested under state and federal law. The provisions not only must purport to bind all of the partners. The provisions must actually bind all of the partners. Future law will determine what is necessary to bind the partners and the partnership. There will be future cases brought by partners or assignees of partnership interests disputing whether they are bound by the election to use liquidation valuation methods.

Consider, in drafting your partnership agreement, including a provision that specifically addresses these rules. Provide:
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- An acknowledgement that the provision is intended to be legally binding on all of the partners (including assignees who are treated as tax partners but who are not treated as substituted partners for state law purposes).
- A statement that your partnership is authorized and directed to elect the safe harbor.
- A statement that your partnership and each of its partners (including any person to whom a partnership interest is transferred in connection with the performance of services) agrees to comply with all requirements of the safe harbor with respect to all partnership interests transferred in connection with the performance of services while the liquidation-of-the-partnership valuation election remains effective.
- A provision that the person to whom a partnership interest is transferred assumes the transferring partner’s obligations under your partnership agreement.
- Possibly a remedy if the agreement is breached.

This provision is an attempt to comply with the Proposed Treasury Regulations:

Section x.x. Section 1.83-3(1) Compliance. Each Member shall comply (and shall cause the Company to comply) with all of the requirements of the safe harbor set forth in Proposed Treasury Regulations Section 1.83-3(1) (the “Safe Harbor”), and any corresponding future provision of the Code or the Treasury Regulations. Each Member agrees that the fair market value of any Interest that is transferred in connection with the performance of services is treated as being equal to the liquidation value of that Interest. Each Member acknowledges that this provision is intended to be legally binding of all of the Members (including assignees who are treated as tax partners but who are not treated as substituted partners for state law purposes). The Company is authorized and directed to elect the Safe Harbor. The Company and each Member (including any person to whom an Interest is transferred in connection with the performance of services) agrees to comply with all requirements of the Safe Harbor with respect to all Interests transferred in connection with the performance of services while the Safe Harbor election remains effective. The person to whom an Interest is transferred assumes the transferring Member’s obligations under this Section x.x.

Another provision addresses this problem when the partnership interests are restricted:
Section x.x. Membership Interests Received for Services.

(a) A Person who receives a Membership Interest in connection with the performance of services to or for the benefit of the Company, that is not substantially vested (within the meaning of Treasury Regulations Section 1.83-3(b)), shall timely file an election under Section 83(b) of the Code with respect to the substantially nonvested portion of the Membership Interest.

(b) In connection with the grant of a Membership Interest to a Person in connection with the performance of services to or for the benefit of the Company (except as otherwise required by applicable law):

(1) The Person shall be treated as receiving the Membership Interest on the date of grant;

(2) The Person shall take into account the distributive share of Company income, gain, loss, deduction and credit associated with the Membership Interest for the entire period during which the Person has held the Membership Interest (without regard to any vesting schedule that may apply to the Interest); and

(3) Upon the grant of the Membership Interest or at the time the Membership Interest becomes substantially vested, neither the Company nor any Member may deduct any amount (as wages, compensation or otherwise) for the fair market value of the Membership Interest.

(c) If Treasury Regulations or other rules similar to Proposed Treasury Regulations Section 1.83-3(1)(1)(ii) (or the safe harbor contained in the proposed Revenue Procedure contained in Notice 2005-43) are promulgated (with respect to each grant of a Membership Interest for services):

(1) The Company is authorized and directed to elect the safe harbor under which the fair market value of the Membership Interest is treated as being equal to its liquidation value; and

(2) The Company and each Member (including (without prejudice to generality) the Person to whom the Membership Interest is granted) shall comply with all requirements of the safe harbor with respect to all Membership Interest granted in connection with the performance of services.

(d) If Treasury Regulations or other rules similar to Proposed Treasury Regulations Section 1.704-1(b)(4)(xii) are promulgated, forfeiture allocations shall be made to the Member in the amount and manner set forth in these Treasury Regulations with respect to each substantially non-vested Membership Interest of a Member that is forfeited.
The valuation election continues in effect until terminated. The liquidation-of-the-partnership valuation election terminates—

- When your partnership fails to satisfy the requirements of the revenue procedure.
- When your partnership, a partner, or service partner reports income tax effects of a Partnership interest subject to the valuation election in a manner inconsistent with the requirements of this revenue procedure, including a failure to provide appropriate information returns.
- By your partnership preparing a document, executed by a partner who has responsibility for federal income tax reporting by your partnership, indicating that your partnership, on behalf of your partnership and each of its partners, is revoking its valuation election under Revenue Procedure 200X-XX and the effective date of the revocation. The immediately previous sentence is qualified by the requirement that the effective date may not be prior to the date the election to terminate is executed. The termination election must be attached to the tax return for your partnership for the taxable year that includes the effective date of the election.

The unilateral act by any of the partners can void the valuation election. This is a serious consequence. Your partnership agreement should bind partners to consistent reporting and perhaps provide a remedy against the partner who fails to abide by this agreement.

The rules of the safe harbor do not apply to any partnership interests transferred on or after the date of a termination of the liquidation-of-the-partnership valuation election but continue to apply to any partnership interest subject to the valuation elections transferred while the liquidation-of-the-partnership valuation election was in effect.

Your partnership might have made a liquidation-of-the-partnership valuation election and the election might have been terminated. Absent the consent of the Commissioner, the partnership (and any successor partnerships) is not eligible to make a liquidation-of-the-partnership valuation election for any taxable year that begins before the fifth calendar year after the calendar year during which the termination occurs. A successor partnership is any partnership that (1) on the date of the termination, is related\(^{723}\) to the partnership whose liquidation-of-the-partnership valuation election has terminated (or, if the partnership liquidation-of-the-partnership valuation election has terminated does not exist on the date of

\(^{723}\) Within the meaning of I.R.C. § 267(b) or I.R.C. § 707(b).
termination would be related if it existed on this date), and (2) acquires (either
directly or indirectly) a substantial portion of the assets of the partnership whose
election has terminated.

An old partnership whose liquidation-of-the-partnership valuation election
has terminated can infect a new partnership to which the first partnership’s assets
are transferred. This should be addressed by appropriate representations and war-
ranties in the contribution agreement or your partnership agreement.

The liquidation-of-the-partnership valuation election imposes recordkeep-
ing requirements. Your partnership is required to keep as records:

- A copy of the liquidation-of-the-partnership valuation election
  submitted by your partnership to the Service, and
- If applicable, the original of each document submitted to your
  partnership by a partner binding the partner to report in accordance
  with the revenue procedure. Your partnership might be unable to
  produce a record of a particular document. The liquidation-of-the-
  partnership valuation election will be treated as not made, generally
  resulting in termination of the liquidation-of-the-partnership
  valuation election.

Address the maintenance of these records. The Proposed Treasury Regu-
lations impose a serious penalty for failure to retain the liquidation-of-the-
partnership valuation election.

A service partnership interest is treated as substantially vested if the right
to the associated capital account balance equivalent is not subject to a “substantial
risk of forfeiture” or the partnership interest is transferable.

A service partnership interest is treated as substantially nonvested only if,
under the terms of the partnership interest (at the time of the transfer) –

- The partnership interest terminates and the holder may be required
to forfeit the capital account balance equivalent credited to the
holder under conditions that would constitute a “substantial risk of
forfeiture,” and
- The partnership interest is not transferable.

The capital account balance equivalent is the amount of cash that the ser-
cise partner would receive if, immediately prior to the forfeiture, the partnership
interest vested and your partnership sold all of its assets (including goodwill, go-
ing concern value, or any other intangibles associated with your partnership’s op-
erations) for cash equal to the fair market value of those assets and then liquidat-
ed.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

A service partnership interest will not be considered substantially nonvested if the sole portion of the capital account balance equivalent forfeited is the excess of the capital account balance equivalent at the date of termination of services over the capital account balance equivalent at the end of the prior partnership tax year or any later date before the date of termination of services. The service partnership interest is not substantially nonvested if the service partner forfeits only the current year’s allocations.

A service partnership interest with respect to which a Section 83(b) election has been made might be forfeited. The service partner must include as ordinary income in the taxable year of the forfeiture an amount equal to the excess (if any) of –

- The amount of income or gain that your partnership would be required to allocate to the service partner (under Proposed Treasury Regulations Section 1.704-1(b)(4)(xii)) if your partnership had unlimited items of gross income and gain, over

- The amount of income or gain that your partnership actually allocated to the service partner (under Proposed Treasury Regulations Section 1.704-1(b)(4)(xii)).

The service partner’s capital account is increased by the amount the service partner takes into income under Section 83 as a result of receiving the service partnership interest, plus any amounts paid by the service partner for the partnership interest. This is a sore point with many draftsmen of partnership agreements. Consider this effect in drafting your partnership agreement. The capital account credit to the service partner for the amount of income recognized by the service partner can distort the economics of the partnership arrangement.

If an election under Section 83(b) has been made with respect to a substantially nonvested interest, the holder may be allocated partnership items that may later be forfeited. Allocations of partnership items while the partnership interest is substantially nonvested cannot have economic effect. The Proposed Treasury Regulations treat these allocations as being in accordance with the partners’ interests in the partnership if:

- Your partnership agreement requires that your partnership make forfeiture allocations to the forfeiting service partner if the partnership interest for which the Section 83(b) election is made is later forfeited, and

---

724 Although forfeiture allocations are made to the service partner, an allocation of gross deductions to the service partner has the effect of allocating greater (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- All material allocations and capital account adjustments under your partnership agreement not pertaining to substantially nonvested partnership interests for which a Section 83(b) election has been made are recognized under Section 704(b).

Time will tell how this rule will be applied in practice. The rule apparently overrides other considerations that might apply in determining the validity of the allocations.

This safe harbor does not apply if (at the time of the Section 83(b) election) a plan exists for a substantially nonvested interest to be forfeited. The partners’ distributive shares of partnership items then are determined in accordance with the partners’ interests in the partnership. This creates challenges concerning how the partners’ interests in the partnership will be determined.

Forfeiture allocations are allocations to the service partner of partnership gross income and gain or gross deduction and loss (to the extent items are available) that offset prior distributions and allocations of partnership items with respect to the forfeited partnership interest. These rules are designed to ensure that any partnership income (or loss) that was allocated to the service partner prior to the forfeiture is offset by allocations on the forfeiture of the partnership interest. These rules seek to carry out the prohibition under Section 83(b)(1) on deductions with respect to amounts included in income under Section 83(b). These rules generally cause a forfeiting partner to be allocated partnership income to offset any distributions to the partner that reduced the partner’s basis in the partnership below the amount included in income under Section 83(b).

Forfeiture allocations may be made out of the partnership’s items for the entire taxable year. Your partnership generally will have gross income in the taxable year of the forfeiture equal to the amount of the allowable deduction to the service recipient partnership upon the transfer of the partnership interest as a result of the making of the Section 83(b) election, regardless of the fair market value of your partnership’s assets at the time of forfeiture. \[725\]

The proposed regulations would add a new Treasury Regulations Section 1.704-1(b)(4)(xii) concerning substantially nonvested interests. This provision income to the other partners. The Treasury Regulations perhaps could have allowed the service partner a loss outside the partnership for his tax basis attributable to the partnership income he was allocated in excess of distributions. That loss would not have affected the other partners currently. The Treasury Regulations elected, in effect, to undo the income allocations to the service partner through forfeiture allocations.

Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

A provision would govern restricted partnership interests when a Section 83(b) election has been made to include these interests income prior to substantial vesting. This new provision clarifies that:

If a section 83(b) election has been made with respect to a substantially nonvested interest, the holder of the nonvested interest may be allocated partnership income, gain, loss, deduction, or credit (or items thereof) that will later be forfeited. For this reason, allocations of partnership items while the interest is substantially nonvested cannot have economic effect.\(^{726}\)

The Proposed Treasury Regulations would create a safe harbor under which an allocation of income or loss would be respected with respect to this substantially nonvested interest. The allocation during the period during which the partnership interest is substantially nonvested will be treated as being in accordance with partners’ interests in the partnership if a Section 83(b) election has been made and these two tests are met:

1. The partnership agreement requires that the partnership make forfeiture allocations if the interest for which the section 83(b) election is made is later forfeited; and

2. All material allocations and capital account adjustments under the partnership agreement not pertaining to substantially nonvested partnership interests for which a section 83(b) election has been made are recognized under section 704(b).\(^{727}\)

Just exactly what this means is still a matter of conjecture. The IRS legitimately might be concerned that allocations to the nonvested partner might be used improperly to divert taxable income to a tax-indifferent or low-tax-bracket partner, with that allocation not having economic substance. The Proposed Treasury Regulations would immunize the allocation to the nonvested partner from the requirements of substantiality – or economic effect. How this provision will be interpreted, whether this provision will constitute a yellow brick road to tax abuse, and whether the IRS may modify this provision are matters for the future to resolve.

The service partner who made the Section 83(b) election may later forfeit his partnership interest. The Proposed Treasury Regulations require that the partnership make forfeiture allocations in connection with this forfeiture. Treasury Regulations explain these forfeiture allocations:

---


(c) Forfeiture allocations. Forfeiture allocations are allocations to the service provider (consisting of a pro rata portion of each item) of gross income and gain or gross deduction and loss (to the extent such items are available) for the taxable year of the forfeiture in a positive or negative amount equal to –

1. The excess (not less than zero) of the –
   (i) Amount of distributions (including deemed distributions under section 752(b) and the adjusted tax basis of any property so distributed) to the partner with respect to the forfeited partnership interest (to the extent such distributions are not taxable under section 731); over
   (ii) Amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under section 752(a)) to the partnership with respect to the forfeited partnership interest; minus

2. The cumulative net income (or loss) allocated to the partner with respect to the forfeited partnership interest.

(d) Positive and negative amounts. For purposes of paragraph (b)(4)(xii)(c) of this section, items of income and gain are reflected as positive amounts, and items of deduction and loss are reflected as negative amounts.

We can glean a number of features of forfeiture allocations from this Proposed Treasury Regulations. Forfeiture allocations are allocations to the service provider. We can infer that these are allocations of “book” items and not direct allocations of tax items. Forfeiture allocations are gross “book” allocations. Forfeiture allocations consist of a pro rata portion of each item of partnership gross income and gain or a pro rata portion of each item of partnership gross deduction and loss (to such extent items are available) for the taxable year of the forfeiture. The reference to “to the extent such items are available” would seem to be a reference to items allocated under the minimum gain chargeback, partner minimum gain chargeback, and nonrecourse deductions or partner nonrecourse deductions – items that are automatically allocated under specific regulatory provisions. As a consequence, forfeiture allocations may be incomplete.

Forfeiture allocations to the service provider do not necessarily eliminate the positive capital account of the service partner, as we might suppose. Forfeiture allocations are made to the service provider in a positive or negative amount equal to –

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- The excess (not less than zero) of the –
  - Amount of distributions (including deemed distributions on account of relief of liabilities under the partnership rules for allocating liabilities among partners (Section 752(b)) and the adjusted tax basis of any property distributed to the forfeiting partner) to the partner with respect to the forfeited partnership interest (to the extent that the distributions are not taxable under Section 731 [governing distributions of cash in excess of a partner’s basis in his partnership interest]); over
  - Amounts paid for the interest and the adjusted tax basis of property contributed by the partner (including deemed contributions under the partnership rules for allocating liabilities among partners (Section 752(a)) to the partnership with respect to the forfeited partnership interest; minus
- The cumulative net [“book”] income (or [“book”] loss) allocated to the partner with respect to the forfeited partnership interest.

A “book” allocation of income is made to the service partner as a forfeiture allocation if the amount determined by this process results in a positive number. A “book” allocation of loss is made to the service partner as a forfeiture allocation if the amount determined by this process results in a positive number. 729

The excess computed above could be considered the net prior nontaxable distributions to the partner over the amount contributed by the partner. The forfeiture allocations should result in an income allocation to the forfeiting partner to the extent that the partner has received net nontaxable distributions (over contributions) over prior allocations of “book” income.

Your partnership may not have enough income and gain fully to offset prior allocations of loss to the forfeiting service partner. This will result in recapture of losses taken by the service partner prior to the forfeiture of the partnership interest to the extent that those losses are not recaptured through forfeiture allocations of income and gain to the service partner. This rule does not provide the other partners in your partnership with the opportunity to increase their shares of partnership loss (or to reduce their shares of partnership income) for the partnership’s taxable year of the forfeiture by the amount of loss that was previously allocated to the forfeiting service partner.

Your partnership may not have enough deductions and loss fully to offset prior allocations of income to the forfeiting service partner. A forfeiting partner is

entitled to a loss for any basis in a partnership that is attributable to contributions of money or property to the partnership (including amounts paid for the partnership interest) remaining after the forfeiture allocations have been made. This loss often will be a capital loss.

The safe harbor for Section 83(b) elections that respects allocations to the partner making a Section 83(b) does not apply to allocations of partnership items made with respect to a substantially nonvested interest for which the holder has made a section 83(b) election if (at the time of the section 83(b) election) a plan exists that the interest will be forfeited. Then, the partners’ distributive shares of partnership items are determined in accordance with the more general standard of partners’ interests in the partnership. The Proposed Treasury Regulations provide that, in determining whether a plan exists that the interest will be forfeited, the Commissioner will consider all of the facts and circumstances (including the tax status of the holder of the forfeitable compensatory partnership interest). 730

73. Series Entities.

Series partnerships and limited liability companies are perhaps the most revolutionary entities available. 731 Drafting for a series limited liability is a challenge.

---

731 See REG-119921-09, 75 Fed. Reg. 55699-55709 (September 14, 2010).

The National Commissioners on Uniform Laws adopted the Revised Uniform Limited Liability Company Act in July 2006. The revised act does not incorporate provisions for series limited liability companies. See, for example, Michael W. McLoughlin & Bruce P. Ely, “The Series LLC Raises Serious State Tax Questions but Few Answers Are Yet Available,” JOURNAL OF MULTISTATE TAXATION AND INCENTIVES 8 (January 2007); Thomas E. Rutledge, “To Boldly Go Where You Have Not Been Told You May Go: LLCs, LLPs, and LLLPs in Interstate Transactions,” 58 BAYLOR L. REV. 205 (Winter 2006); Gerson, “Taxing Series LLCs,” 45 TAX MANAGEMENT MEMORANDUM 75 (March 8, 2004); Terence Floyd Cuff, “Series LLCs and the Abolition of the Tax System,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006. On series business trusts, generally, see LTR 200637018 (June 1, 2006); LTR 200544018 (; June 1, 2005); TAM 200512020 (August 20, 2004); LTR 200511004 (December 3, 2004); LTR 200443029 (June 28, 2004); LTR 200440012 (May 17, 2004); LTR 200422052 (February 27, 2004); LTR 200420017 (February 02, 2004); LTR 200403025 (September 30, 2003); LTR 200327028 (March 25, 2003); LTR (footnote continued on the next page)
Series partnerships permit different classes of interests associated with different classes of assets. Some advisors advise that Delaware series Limited liability companies are the ideal manner in which to own multiple real properties. Other advisors prefer to have a single master limited liability company with a subsidiary single member limited liability company owning each separate real property.

Series entities are generally taxed as separate partnerships. The economic interests can be varied across classes. The series can be established so that liability-
ties of one series will not infect assets of another series. There may be series of members, managers or limited liability company interests. These interests may have separate rights, powers or duties with respect to specified property or obligations of the limited liability company or profits and losses associated with specified property or obligations, and any series may have a separate business purpose or investment objective. There is uncertainty in how liability protections that appear to be afforded to a series’ assets will be treated outside of the jurisdiction under whose laws the series limited liability company is formed (except in jurisdictions that expressly respect series limited liability companies and recognize the inter-series liability shield). There typically is uncertainty how series entities will perform outside of the limited liability company act under which they are formed. This includes subdivision laws, building laws, water laws, bankruptcy laws, labor laws, franchise laws, agricultural laws, etc.

The Delaware Limited Liability Company Act permits the limited liability company agreement to provide for the establishment of 1 or more series of membership interests. The law requires that:

[I]n the event that a limited liability company agreement establishes or provides for the establishment of 1 or more series, and if separate and distinct records are maintained for any such series and the assets associated with any such series are held in such separate and distinct records (directly or indirectly, including through a nominee or otherwise) and accounted for in such separate and distinct records separately from the other assets of the limited liability company, or any other series thereof, and if the limited liability company agreement so provides, and if notice of the limitation on liabilities of a series as referenced in this subsection is set forth in the certificate of formation of the limited liability company, then the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series shall be enforceable against the assets of such series only, and not against the assets of the limited liability company generally or any other series thereof, and, unless otherwise provided in the limited liability company agreement, none of the debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to the limited liability

732 Particularly see Delaware Limited Liability Company Act § 18-215.
733 The California Franchise Tax Board takes the position that each series is subject to a separate minimum fee payment under the California fee on limited liability companies.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

company generally or any other series thereof shall be enforceable against the assets of such series.\footnote{734}

The series of membership interests should be set forth in the operating agreement. This should describe who is in what series, what the economic interests are, what the voting rights are, and what the management rights are. The operating agreement should describe the assets in each series.

The Delaware laws impose a record maintenance requirement. Separate and distinct records must be maintained for any series. The records should separately show the series assets. The operations of the series should be accounted for in these separate records. This record requirement should be set forth in the operating agreement.

Delaware law requires that notice of the limitation on liabilities of a series must be set forth in the certificate of formation of the limited liability company. This requirement should be set forth in the operating agreement.

The debts, liabilities, obligations and expenses incurred, contracted for or otherwise existing with respect to a particular series can be enforced only against the series assets if these requirements are met. This establishes each series of assets as a separate liability cell, so that liabilities of that cell are limited to the assets of the cell.\footnote{735}

\footnote{734} Delaware Limited Liability Company Act § 18-215(b).

\footnote{735} Delaware law provides that the –
limited liability company agreement may provide for classes or groups of members or managers associated with a series having such relative rights, powers and duties as the limited liability company agreement may provide, and may make provision for the future creation in the manner provided in the limited liability company agreement of additional classes or groups of members or managers associated with the series having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of members or managers associated with the series.

Delaware Limited Liability Company Act § 18-215(d).

Delaware law provides:

A limited liability company agreement may provide for the taking of an action, including the amendment of the limited liability company agreement, without the vote or approval of any member or manager or class or group of members or managers, including an action to create under the provisions of the limited liability company agreement a class or group of the series of limited liability company interests that was not pre-
Delaware law creates huge flexibility in the creation of different series of interests and assets. All of the details of these series should be reflected in your partnership agreement.

Series limited partnerships and series limited liability companies are substantially untested outside of the jurisdictions of their creation. California Corporations Code Section 17450, for example, provides with respect to foreign limited liability companies with operations inside California: “(a) The laws of the state or foreign country under which a foreign limited liability company is organized shall govern its organization and internal affairs and the liability and authority of its managers and members. (b) A foreign limited liability company may not be denied registration by reason of any difference between those laws and the laws of this state.” No California case law yet addresses how the series liability provisions of Delaware law will apply to a Delaware limited liability company with operations in California. State law outside of Delaware might well respect the liability partitions provided by Delaware law, but that is a matter that still is to be tested.

74. Name.

Set forth the name of your partnership and the means by which that name can be changed.

Previously outstanding. A limited liability company agreement may provide that any member or class or group of members associated with a series shall have no voting rights.

Id.

Additionally, [a] limited liability company agreement may grant to all or certain identified members or managers or a specified class or group of the members or managers associated with a series the right to vote separately or with all or any class or group of the members or managers associated with the series, on any matter. Voting by members or managers associated with a series may be on a per capita, number, financial interest, class, group or any other basis.

Delaware Limited Liability Company Act § 18-215(e).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Section x.x. Name. The name of the Partnership is Hummingbird Realty Partners, LP. The General Partner (in its sole and absolute discretion) may change the name of the Partnership. The General Partner shall notify the Limited Partners of the change in the next regular communication to the Limited Partners.

Make sure that the name complies with the requirements of state law.

There may be additional requirements or restrictions under state law concerning certain names. Consider seeking pre-approval from the local Secretary of State’s office concerning the use of a name. Most states will not permit names that will create confusion with other entities. Many states have procedures concerning name reservation.

---

736 Delaware Limited Liability Company Act § 18-102 provides:
§ 18-102. Name set forth in certificate.
The name of each limited liability company as set forth in its certificate of formation:
(1) Shall contain the words “Limited Liability Company” or the abbreviation “L.L.C.” or the designation “LLC”;
(2) May contain the name of a member or manager;
(3) Must be such as to distinguish it upon the records in the office of the Secretary of State from the name on such records of any corporation, partnership, limited partnership, statutory trust or limited liability company reserved, registered, formed or organized under the laws of the State of Delaware or qualified to do business or registered as a foreign corporation, foreign limited partnership, foreign statutory trust, foreign partnership, or foreign limited liability company in the State of Delaware; provided however, that a limited liability company may register under any name which is not such as to distinguish it upon the records in the office of the Secretary of State from the name on such records of any domestic or foreign corporation, partnership, limited partnership, statutory trust or limited liability company reserved, registered, formed or organized under the laws of the State of Delaware with the written consent of the other corporation, partnership, limited partnership, statutory trust or limited liability company (which written consent shall be filed with the Secretary of State); and
(4) May contain the following words: “Company,” “Association,” “Club,” “Foundation,” “Fund,” “Institute,” “Society,” “Union,” “Syndicate,” “Limited” or “Trust” (or abbreviations of like import).

737 Delaware Limited Liability Company Act § 18-103 law, for example, provides:
(footnote continued on the next page)
§ 18-103. Reservation of name.

(a) The exclusive right to the use of a name may be reserved by:

(1) Any person intending to organize a limited liability company under this chapter and to adopt that name;

(2) Any domestic limited liability company or any foreign limited liability company registered in the State of Delaware which, in either case, proposes to change its name;

(3) Any foreign limited liability company intending to register in the State of Delaware and adopt that name; and

(4) Any person intending to organize a foreign limited liability company and intending to have it register in the State of Delaware and adopt that name.

(b) The reservation of a specified name shall be made by filing with the Secretary of State an application, executed by the applicant, specifying the name to be reserved and the name and address of the applicant. If the Secretary of State finds that the name is available for use by a domestic or foreign limited liability company, the Secretary shall reserve the name for the exclusive use of the applicant for a period of 120 days. Once having so reserved a name, the same applicant may again reserve the same name for successive 120-day periods. The right to the exclusive use of a reserved name may be transferred to any other person by filing in the office of the Secretary of State a notice of the transfer, executed by the applicant for whom the name was reserved, specifying the name to be transferred and the name and address of the transferee. The reservation of a specified name may be cancelled by filing with the Secretary of State a notice of cancellation, executed by the applicant or transferee, specifying the name reservation to be cancelled and the name and address of the applicant or transferee. Unless the Secretary of State finds that any application, notice of transfer, or notice of cancellation filed with the Secretary of State as required by this subsection does not conform to law, upon receipt of all filing fees required by law the Secretary shall prepare and return to the person who filed such instrument a copy of the filed instrument with a notation thereon of the action taken by the Secretary of State.

(c) A fee as set forth in § 18-1105(a)(1) of this title shall be paid at the time of the initial reservation of any name, at the time of the renewal of any such reservation and at the time of the filing of a notice of the transfer or cancellation of any such reservation.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Provide for filing or recording of a statement of partnership, a limited liability company certificate or certificate of limited partnership as required by law.

Section x.x. Certificate of Limited Partnership. The General Partner has previously filed the Certificate of Limited Partnership with the Secretary of State of the State of Delaware as required by the Act. The General Partner shall use all reasonable efforts to cause to be filed such other certificates or documents as may be reasonable and necessary or appropriate for the formation, continuation, qualification and operation of a limited partnership (or a partnership in which the limited partners have limited liability) in the State of Delaware and any other state, the District of Columbia or such other jurisdiction, in which the Partnership may elect to do business or own property. To the extent that this action is determined by the General Partner to be reasonable and necessary or appropriate, the General Partner shall file amendments to and restatements of the Certificate of Limited Partnership and do all of the things to maintain the Partnership as a limited partnership (or a partnership in which the limited partners have limited liability) under the laws of the State of Delaware and each other state, the District of Columbia or any other jurisdiction in which the Partnership may elect to do business or own property.

76. Jurisdiction of Organization.

You may not know in what jurisdiction to form a partnership. California attorneys may feel a parochial interest in forming partnerships under California law. New York attorneys likely prefer New York law. Many draftsmen may be more comfortable forming partnerships under Delaware law or perhaps Maryland law. Underwriters of securitized debt may require partnership issuers of securitized debt to be formed under Delaware law. Many partnerships are formed under Nevada law.\(^{738}\)

---

\(^{738}\) Consider the form of entity—general partnership, limited partnership, limited liability partnership, limited liability limited partnership, or limited liability company. Your decision process should include tax treatment under local law.
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

Section x.x. Formation. The parties have formed the Company as a limited liability company under the Act on * * *. A certificate of formation for the Company as described in Section 18-201 of the Act (the “Certificate of Formation”) has been filed in the Office of the Secretary of State of the State of Delaware in conformity with the Act on * * *. You may decide to form your partnership under the law of the jurisdiction in which your partnership will have its principal place of business, or in the jurisdiction in which it will conduct its principal operations.

No solution is correct for all partnerships. Understand the partnership laws of the jurisdiction in which you form your partnership. You may become lost in subtleties of local law if you form partnerships under the laws of many different jurisdictions. Most jurisdictions conform substantially to uniform acts governing partnerships. Courts of one jurisdiction may well apply the decisional law of another jurisdiction. Adapt your partnership agreement in accordance with the laws of your partnership’s jurisdiction of formation. Verifying that a partnership agreement that satisfies the laws of one state can be used in another can be expensive. Involve local counsel to review your partnership agreement if you form a partnership under the laws of a jurisdiction in which you do not practice.

Some draftsmen imagine that they will achieve state tax planning advantages by forming a partnership under the laws of a specific jurisdiction. You likely will not find material tax planning advantages in forming a partnership under the laws of a particular jurisdiction.\(^{739}\)

Delaware law can offer some advantages that can be important for certain purposes. Delaware has developed the largest and most robust body of case law on partnerships. The Delaware Chancery Court is familiar with and has an excellent reputation in handling business disputes. Resolving disputes in Delaware Chancery Court avoids jury trials. Jury trials may be available in other states. Delaware law is flexible in permitting your partnership agreement to waive or to define fiduciary duties. Delaware law is flexible on remedies to address defaults in capital contributions and other breaches of your partnership agreement. Delaware law permits series partnerships with limited liability among the various series of assets of your partnership.\(^{740}\) The State of Delaware permits quick filing by facsimile. Merging entities can be more efficient if all entities are formed under Delaware law. Finally, local draftsmen in different states are more likely to be

---

\(^{739}\) However, some states will impose franchise or other taxes or fees on partnerships or limited liability companies. Consider state tax aspects of organizing your partnership.

\(^{740}\) See Delaware Limited Liability Company Act § 18-215.
familiar with Delaware law governing partnerships than they are with the laws of
other jurisdictions with the exception of their own. Maryland and Nevada are
attractive jurisdictions for forming partnerships.

77. **Intent to Form a Partnership.**

Your partnership agreement may contain language reaffirming the intent
of the parties to be treated as a partnership:

Section x.x. *Operation as a Partnership.* The Partners intend that the
Partnership be operated in a manner consistent with its treatment as a
“partnership” for Federal and state income tax purposes and for corpo-
rate purposes. No Partner shall take any action inconsistent with that ex-
press intent. No Partner shall file an election to be taxable as a corpora-
tion or association under Treasury Regulations Section 301.7701-3 or any
successor provision.

78. **Limited Liability.**

Your partnership agreement may contain a reaffirmation that the partners
intend that your partnership be operated as a limited liability entity. These provi-
sions may make the partners more comfortable, but it is not clear that these provi-
sions add anything to the protections of state law. This is an example:

Section x.x. *Limited Liability.* Except as otherwise required by the Del-
aware Act, the debts, obligations and liabilities of the Company (whether
arising in contract, tort or otherwise) shall be solely the debts, obligations
and liabilities of the Company. No Member (including (without prejudice
to generality) any Person who formerly held the status as a Member) shall
be liable or shall be obligated personally for any debt, obligation or li-
ability of the Company solely by reason of that status. No individual trustee,
officer, director, shareholder, member, manager, constituent partner, em-
ployee, agent or attorney of any entity Member (in his individual capacity
as such) has any personal liability for the performance of any obligation
of that Member under this Agreement.

79. **Term.**

The best term of your partnership often is an unlimited term. You may
wish to use a limited term to force a liquidation of your partnership after a fixed
period of time. A minority partner may insist on a limited term to ensure that your
partnership will sell its assets and liquidate within a reasonable period of time.
Section x.x. Term. The term of the Partnership commenced on January 1, 2007. This is the date when the original Certificate of Limited Partnership was filed with the Secretary of State of the State of Delaware. The term of the Partnership shall continue until the Partnership is dissolved and terminated in accordance with Article X of this Agreement or as otherwise provided by law.

80. Qualification.

Your partnership should be required to qualify in those foreign states in which it undertakes business, as required by state law.

Section x.x. Qualification in Other Jurisdictions. The Management Committee shall cause the Company to be qualified or registered –

(a) As a foreign limited liability company under the *** Act, and shall cause this status to be maintained for so long as the Company owns any real property or otherwise transacts business, in the State of ***; and

(b) Under the assumed or fictitious name statutes or similar laws in the State of *** and in any other jurisdiction in which the Company transacts business.

*** (as an authorized Person within the meaning of the Delaware Act) shall execute, deliver and file any certificates (and any amendments and/or restatements thereof) necessary for the Company to qualify to do business in the State of *** or in any other jurisdiction in which the Company may wish to conduct business.

81. Purposes.

Section x.x. Purpose. The purpose of the Company shall be to engage in any lawful activity for which a limited liability company may be organized under the Act.

The purposes of your partnership limit the scope of its business. Purposes of the partnership also limit the scope of fiduciary duties that partners owe to the partnership and to one another. The purposes provision in your partnership agreement can force dissolution of a partnership upon the sale of an apartment
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

project and can prevent a like-kind exchange of the partnership’s assets. The purpose perhaps should be sufficiently flexible to permit a like-kind exchange if your client desires your partnership to undertake an exchange in the future. A like-kind exchange might be prohibited if that suits your client’s interests. Consider limiting the purpose of an investment partnership, in appropriate circumstances, to investment activities in order to prevent subdivision and sale of real property or perhaps conversion of apartments to condominiums. Some state statutes limit the business that can be undertaken by a limited liability company.

This is a light-duty purposes provision for a real estate subdivision partnership:

---

On permitted businesses, see Delaware Limited Liability Company Act § 18-106(a) (“§ 18-106. Nature of business permitted; powers. (a) A limited liability company may carry on any lawful business, purpose or activity, whether or not for profit, with the exception of the business of banking as defined in § 126 of Title 8.”). Some partnership agreements will permit an exchange despite the objections of one of the partners. See Trump v. Cheng, Index No. 602877/05 (N.Y. Supreme Court (September 14, 2005)) (in this case, a real estate investor, Donald Trump, failed in his argument that the partnership was not permitted to undertake an exchange of the former Penn Central rail yards on the Hudson River waterfront for the Bank of America building in San Francisco).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Section x.x. Purpose. The purpose of the Company shall be:

(a) To acquire, to own, to hold, to manage, to maintain, to operate, to develop, to finance, to improve, to construct, to lease, to sell, to exchange or otherwise to dispose of such residential real estate acquisition and development projects as the Members may approve.

(b) To obtain any and all entitlements and/or other land use planning approvals necessary in connection with these residential real estate acquisition and development projects.

(c) To cause these residential real estate acquisition and development project properties to be subdivided into multiple residential lots as may be approved by the Manager (collectively, the “Lots” and individually, a “Lot”).

(d) To develop and to construct upon these Lots improvements, infrastructure improvements, parks, schools and any and all related improvements that are approved by the Manager (collectively, the “Improvements”).

(e) To own, to maintain, to manage, to hold for investment, to market, to sell to merchant builders and otherwise to realize the economic benefit from the Lots and their related Improvements.

(f) To borrow money and to issue evidences of indebtedness to finance the activities set forth in clauses (a) through (e) above.

(g) To conduct those other activities with respect to the Lots and the Improvements as are necessary and/or appropriate to accomplish the foregoing activities.

(h) To do any and all other acts or things that may be incidental or necessary to carry on the business of the Company.

This provision is designed for a real estate investment partnership:
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Section x.x. Purpose of Company. The purpose of the Company shall be to engage in any lawful activity for which a limited liability company may be organized under the Act; however, the primary purpose of the Company shall be:

(a) To acquire, to own, to hold, to manage, to maintain, to operate, to lease, to sell, to exchange, and to conduct any other similar or related activity with respect to that certain real property improved with an industrial project located in Rancho Cucamonga, California, and more particularly described on Exhibit X (the “Property”).

(b) To borrow money and to issue evidences of indebtedness to finance the activities set forth in clause (a) above.

(c) To do any and all other acts or things that may be incidental or necessary to carry on the business of the Company as described in this Section y.y.

82. Powers.

Many draftsmen are inclined to make the powers of a partnership expansive. A lender or an investor may insist on limited powers in order to control the scope of the business. Clearly state the powers of your partnership. Consider giving a general statement of powers, followed by more specific examples. Consider illustrating specific powers to comfort bankers, brokers, etc. Tailor powers to your particular partnership agreement.

Delaware law provides:


* * * *

(b) A limited liability company shall possess and may exercise all the powers and privileges granted by this chapter or by any other law or by its limited liability company agreement, together with any powers incidental thereto, including such powers and privileges as are necessary or convenient to the conduct, promotion or attainment of the business, purposes or activities of the limited liability company.

(c) Notwithstanding any provision of this chapter to the contrary, without limiting the general powers enumerated in subsection (b) of this section, a limited liability company shall, subject to such standards and restrictions, if any, as are set forth in its limited liability company agreement, have the power and authority to make contracts of guaranty and suretyship and enter into interest rate, basis, currency, hedge or other
swap agreements or cap, floor, put, call, option, exchange or collar agreements, derivative agreements, or other agreements similar to any of the foregoing.\footnote{742}{Delaware Limited Liability Company Act § 18-106.}

This provision is typical of a powers provision:

Section x.x. Powers of the Company. The Company has the power to take any and all actions necessary, convenient, desirable or incidental to the purpose set forth in Section y.y. This power includes (without prejudice to generality) the power:

(a) To conduct its business, to carry on its operations and to have and to exercise the powers granted to a limited liability company by the Delaware Act in the State of Montana or in any other state, territory, district or possession of the United States, or any foreign country that may be necessary, convenient or incidental to the accomplishment of the purpose of the Company.

(b) To acquire, to own, to hold, to operate, to maintain, to finance, to improve, to construct, to renovate, to expand, to lease, to sell, to convey, to mortgage, to transfer, to demolish or to dispose of all or part of the Project as may be necessary, convenient or incidental to the accomplishment of the purpose of the Company.

(c) To enter into, to perform and to carry out contracts of any kind. This includes (without prejudice to generality) contracts with any Member, any Affiliate thereof or any agent of the Company necessary, convenient, desirable or incidental to the accomplishment of the purpose of the Company.

(d) To sue and to be sued, to complain and to defend and to participate in administrative or other proceedings, in its name.

(e) To appoint officers, employees and agents of the Company, to define their duties and to fix their compensation (if any).

(f) To indemnify any Person in accordance with the Delaware Act and to obtain any and all types of insurance.

(g) To cease its activities and to cancel its Certificate of Formation.

(h) To negotiate, to enter into, to renegotiate, to extend, to renew, to terminate, to modify, to amend, to waive, to execute, to acknowledge or to take any other action with respect to any lease, con-
trant, agreement, deed of trust, mortgage, loan agreement or other loan
document or security agreement in respect of the Project.

(i) To borrow money and to issue evidences of indebtedness,
and to secure these borrowings by a mortgage, deed of trust, security
agreement, pledge, collateral assignment, or other lien on the assets of the
Company.

(j) To pay, to collect, to compromise, to litigate, to arbitrate or
otherwise to adjust or to settle any and all other claims or demands of or
against the Company or to hold these proceeds against the payment of
contingent liabilities.

(k) To make, to execute, to acknowledge and to file any and all
documents or instruments necessary, convenient, desirous or incidental to
the accomplishment of the purpose of the Company.

Partnerships often will be required by lenders to adopt restrictions on the
powers and activities of the partnership in order to meet requirements of lenders.
These restrictions typically address lender concerns that the entity might be con-
solidated in a bankruptcy of a partner if the partner should become bankrupt. This
is a typical set of activity restrictions that might be required by a lender:

Section x.x. Restrictions on Company Activities. As long as that certain
loan in the approximate amount of One Hundred Million Dollars
($100,000,000) (the “Big Bank Loan”) from Big Bank (the “Lender”), to
Company, as Borrower, is outstanding.

(a) The Company shall not:

(1) Engage in any business or activity other than the
operation and maintenance of, the Property and any activities incidental
to that business or activity.

(2) Acquire or own any material assets other than (a) a
fee interest in the Property, and (b) such incidental machinery, equipment,
fixtures and other personal property as may be necessary for the oper-
ation of the Property.

(3) Merge into or consolidate with any Person or dis-
solve, terminate or liquidate in whole or in part, transfer or otherwise dis-
pose of all or substantially all of its assets or change its legal structure,
without in each case the Lender’s consent.

(4) Fail to preserve its existence as a limited liability
company, validly existing and in good standing (if applicable) under the
laws of the jurisdiction of its organization or formation, or (without prior
written consent of the Lender) amend, modify, terminate or fail to comply
with this Agreement (as it may be further amended or supplemented, if the amendment, modification, termination or failure to comply would adversely affect its ability to perform its obligations under this Agreement, under the note or any other document evidencing or securing the Big Bank Loan).

(5) Own any subsidiary, or make any investment in, any Person without the consent of the Lender.

(6) Commingle its assets with the assets of any of its Members, Affiliates or principals, or of any other Person.

(7) Incur any debt, secured or unsecured, direct or contingent (including (without prejudice to generality) guaranteeing any obligation), other than the Loan and trade payables incurred in the ordinary course of business, provided same are paid when due.

(8) Fail to maintain its records, books of account and bank accounts separate and apart from those of its Members, principals and Affiliates, the Affiliates of any of its Members, principals, and any other Person.

(9) Enter into any contract or agreement with any of its Members, principals or Affiliates, or the Affiliates of any of its Members or principals, except upon terms and conditions that are intrinsically fair and substantially similar to those that would be available on an arm’s-length basis with third parties.

(10) Seek its dissolution or winding up in whole, or in part.

(11) Maintain its assets in such a manner that it will be costly or difficult to segregate, ascertain or identify its individual assets from those of any of its Members, principals and Affiliates, the Affiliates of any of its Members or principals or any other Person.

(12) Hold itself out to be responsible for the debts of another Person.

(13) Make any loans or advances to any third party (including (without prejudice to generality) any of its Members, principals or Affiliates, or the Affiliates of any of its Members or principals).

(14) Fail to file its own tax returns.

(15) Agree to, enter into or consummate any transaction that would render it unable to confirm that –
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(A) It is not an “employee benefit plan” (as defined in Section 3(32) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")) that is subject to Title I of ERISA, or a “governmental plan” (within the meaning of Section 3(32) of ERISA);

(B) It is not subject to state statutes regulating investments and fiduciary obligations with respect to governmental plans; and

(C) Less than twenty five percent (25%) of each of its outstanding class of equity interests are held by “benefit plan investors” within the meaning of 29 C.F.R. § 2510.3-101(f)(2).

(16) Fail either to hold itself out to the public as a legal Person separate and distinct from any other Person or to conduct its business solely in its own name in order not –

(a) To mislead others as to the identity with which the other party is transacting business, or

(b) To suggest that it is responsible for the debts of any third party (including (without prejudice to generality) any of its Members, principals or Affiliates, or any general partner, principal or Affiliate thereof); or

(17) Fail to maintain adequate capital for the normal obligations reasonably foreseeable in a business of its size and character and in light of its contemplated business operations, so long as this capital is available from the business and assets of the Company.

(b) The Company shall not cause or permit the commencement of any case, proceeding or other action –

(1) Under any existing or future law of any jurisdiction, domestic or foreign, relating to bankruptcy, insolvency, reorganization, conservatorship or relief of debtors, seeking to have an order for relief entered with respect to it, or seeking to adjudicate it a bankrupt or insolvent, or seeking reorganization, arrangement, adjustment, winding-up, liquidation, dissolution, composition or other relief with respect to it or its debts; or

(2) Seeking appointment of a receiver, trustee, custodian, conservator or other similar official for it or for all or any substantial part of its assets, or make a general assignment for the benefit of its creditors.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

These covenants are often guaranteed by partners. The enforceability of these provisions by a lender (particularly those provisions concerning bankruptcy) is left to another forum.

83. Temporary Investments.

Consider a provision limiting the investment of partnership funds that are not yet needed in partnership operations. A typical, light duty provision might provide:

Section x.x. Temporary Investments. The General Partner shall invest all Partnership funds that are not immediately needed in the business of the Partnership in one or more of these investments:

(a) Obligations backed by the full faith and credit of the United States of America.

(b) Bank repurchase agreements.

(c) Demand accounts with a federally chartered national bank with assets of no less than $X.

(d) Negotiable certificates of deposit issued by a federally chartered national bank with assets of no less than $X.

(e) Commercial paper.

(f) Bankers acceptances.

(g) Money market funds that invest primarily in United States Government securities.

Partnership funds shall be held in the name of the Partnership and shall not be commingled with those of any other Person. Partnership funds shall be used by the General Partner only for the business of the Partnership.

84. Power of Attorney.

Consider a power of attorney provision that permits a general partner or a manager to undertake various ministerial acts. This is an example:

Section x.x. Power of Attorney.

(a) Each Limited Partner and each Assignee irrevocably appoints the General Partner, any Liquidator, and authorized officers and attorneys-in-fact of each, and each of those acting singly (in each case...
with full power of substitution) as its true and lawful agent and attorney-in-fact, with full power in its name, place and stead:

(i) To execute, to swear to, to seal, to acknowledge, to deliver, to file and to record in the appropriate public offices –

(A) All certificates, documents and other instruments (including (without prejudice to generality) this Agreement and the Certificate of Limited Partnership and all amendments, supplements or restatements thereof) that the General Partner or the Liquidator (in its sole and absolute discretion) deems appropriate or necessary to form, to qualify or to continue the existence or qualification of the Partnership as a limited partnership (or a partnership in which the limited partners have limited liability to the extent provided by applicable law) in the State of Delaware and in all other jurisdictions in which the Partnership may or plans to conduct business or own property;

(B) All instruments that the General Partner deems appropriate or necessary to reflect any amendment, change, modification or restatement of this Agreement in accordance with its terms;

(C) All conveyances and other instruments or documents that the General Partner as the Liquidator or the Liquidator deems appropriate or necessary to reflect the dissolution and liquidation of the Partnership (including, without prejudice to generality), a certificate of cancellation;

(D) All conveyances and other instruments or documents that the General Partner or the Liquidator deems appropriate or necessary to reflect the distribution or exchange of assets of the Partnership;

(E) All instruments relating to the admission, withdrawal, removal or substitution of any Partner under this Agreement or the Capital Contribution of any Partner; and

(F) All certificates, documents and other instruments relating to the determination of the rights, preferences and privileges of Partnership Interests; and

(ii) To execute, to swear to, to seal, to acknowledge and to file all ballots, consents, approvals, waivers, certificates and other instruments appropriate or necessary (in the sole and absolute discretion of the General Partner or the Liquidator), to make, to evidence, to give, to confirm or to ratify any vote, consent, approval, agreement or other action that is made or given by the Partners under this Agreement or is consistent with this Agreement or appropriate or necessary (in the sole and
absolute discretion of the General Partner or the Liquidator), to effectuate the terms or intent of this Agreement.

Nothing contained in this Agreement shall be construed as authorizing the General Partner or any Liquidator to amend this Agreement (except in accordance with Article XX of this Agreement or as may be otherwise expressly provided for in this Agreement).

(b) The foregoing power of attorney is irrevocable and a power coupled with an interest. This recognizes the fact that each of the Partners and Assignees will be relying upon the power of the General Partner and any Liquidator to act as contemplated by this Agreement in any filing or other action by it on behalf of the Partnership. This power of attorney shall survive and not be affected by the subsequent Incapacity of any Limited Partner or Assignee and the Transfer of all or any portion of the Limited Partner’s or Assignee’s Interests (including (without prejudice to generality) the Partnership Interests represented thereby). This power of attorney shall extend to the Limited Partner’s or Assignee’s heirs, successors, assigns and personal representatives. Each Limited Partner or Assignee shall be bound by any representation made by the General Partner or any Liquidator (acting in good faith under the power of attorney). Each Limited Partner or Assignee waives any and all defenses that may be available to contest, to negate or to disaffirm the action of the General Partner or any Liquidator, taken in good faith under the power of attorney. Each Limited Partner or Assignee shall execute and shall deliver to the General Partner or the Liquidator (within five (5) days after receipt of the General Partner’s or Liquidator’s request therefor) any further designation, powers of attorney and other instruments as the General Partner or the Liquidator (as the case may be) deems necessary to effectuate this Agreement and the purposes of the Partnership.

85. Priorities of Partners.

Carefully define any economic priorities of parties (if any exist) or clearly state that the partnership does not have economic priorities.

Section x.x. No Priorities of Members; No Withdrawals of Capital. Except as otherwise specified in this Agreement or in a nonwaivable provision of the Act, no Member has a priority over any other Member as to any Distribution (whether by way of return of capital or by way of profits, or as to any allocation of Net Profits, Net Losses or special allocations). No Member has the right to withdraw or to reduce its Capital Contributions except as a result of the dissolution and liquidation of the Company or as otherwise required by a nonwaivable provision of the Act. No Mem-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

A member has the right to demand or receive property other than cash in return for its Capital Contributions.

Priorities that may exist should be set forth in the distributions provision and in the liquidation provisions.

86. Interest on Capital Contributions.

Carefully state whether capital accounts or capital contributions will bear interest, and, if so, how much, how it is computed, and how it is paid. Clarify whether returns on capital are guaranteed payments or preferred distributions.

87. Elections.

Many tax elections must be made at the partnership level. Clarify who makes these elections and by what standard he or she should be guided. Detail in your partnership agreement what elections should be made. These elections might include:

- The Section 42B targeted jobs credit election.
- The Section 83 valuation election (if it is incorporated in final Treasury Regulations).
- The expense debt allocation election under Treasury Regulations Section 1.163-8T(n)(3).
- Depreciation elections under Treasury Regulations Section 1.167(a)-11(e)(3).
- The election to expense Section 178 property.
- The Section 190 election concerning expenditures to remove architectural and transportation barriers to the handicapped.
- The Section 194 election to amortize reforestation expenditures.
- The (h)(9) gain recognition election under Section 197 regarding amortization of goodwill and intangibles.
- The election to treat employee compensation, overhead, or de minimis costs paid in the process of investigating or otherwise pursuing a transaction as amounts that facilitate the transaction under Section 263.
- The election not to have the rules of Section 263A apply to any plant produced in a farming business.
- A Section 442 election to change accounting period.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- The Section 444 election to use the same taxable year as that of the electing personal service corporation.
- Elections affecting the computation of partnership income under Section 703.
- Election of method to take into account difference between “book” value and adjusted tax basis under the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis.
- Elections of taxable year.
- The Section 709 election to amortize organizational expenses.
- The Section 754 basis adjustment election.
- A Section 871 election to treat real property income as effectively connected with a United States business.
- A Section 988(c)(1)(E)(iii)(V) election regarding treating futures contracts as Section 988 transactions.
- Elections under Section 1033 concerning involuntary conversions.
- A Section 1039 nonrecognition election regarding low income housing property.
- A Section 1295 election regarding a passive foreign investment company that elects status as a qualified electing fund.
- A Section 1361 election regarding earnings from self-employment.
- A Section 1445 election regarding withholding on distributions to foreign partners.
- A Section 1446 tiered partnership election to apply look-through rules, or a partnership election to be taxed as a TEFRA partnership.

The partnership normally makes all elections on the basis of which its income and loss are computed, unless a specific provision exists to the contrary. The partnership will select depreciation methods. The partnership will make any necessary elections to reinvest proceeds of a condemnation. The partnership establishes its own accounting method. The partnership determines its own method of maintaining inventory when this is appropriate. The decision of whether to report gain from an installment sale will be made by the partnership.

This is a simple provision concerning tax elections:

Section x.x. Tax Elections. Except as otherwise expressly required by this Agreement, the Company shall make those tax elections as the Manager may determine. Neither the Managers nor any Member shall elect to treat the Company as an association taxable as a corporation (without

598
prior affirmative vote or unanimous written consent of all of the Members).

This is an example of a provision that specifically addresses the basis adjustment election under Section 754:743

Section x.x Section 754 Election. The Managers (in their sole and absolute discretion) may cause the Company to make an election in accordance with applicable Treasury Regulations to cause the basis of the Company property to be adjusted for federal income tax purposes as provided by Sections 734 and 743 of the Code (and any corresponding elections under state law) if there is an event permitting this election.

88. Tax Notices.

Partnership tax laws require notices to the partnership or to a partner in a variety of situations. Consider making specific provision for these notices in your partnership agreement. Treasury Regulations require that a transferee that acquires, on the death of a partner, an interest in a partnership with an election under Section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner.744 This writ-

743 On Section 754 adjustments, see, generally, Terence F. Cuff, “Bipolar Disorder and the Section 743/755 Regulations,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006, Terence Floyd Cuff, “Bipolar Disorder and the Section 734/755 Regulations,” from Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006.

744 Treas. Reg. § 1.743-1(k)(2) (“Requirement That Transferee Notify Partnership (i) Sale or Exchange. A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee’s basis. (ii) Transfer On Death. A transferee other

(footnote continued on the next page)
89. Admission of Partners.

Address admission of new partners (including capital contributions) and qualification of partners. This is a simple provision concerning admission of new partners:

that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner’s date of death, the date when the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in Section 1014, and the manner in which the fair market value of the partnership interest was determined.\(^{745}\)

\(^{745}\) Treas. Reg. § 1.743-1(k)(2).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Section x.x. Admission of Additional Members. The Manager may admit additional Members to the Company upon those terms and conditions as the Manager may determine. Any additional Members shall be granted Membership Interests and may participate in the Net Profits, Net Losses, Distributable Cash and other Distributions of the Company on those terms as the Manager may fix. This authority is subject to compliance with applicable law. This authority also is subject to the approval of the requisite Members specified in Section y.y.

This is another possibility:

Section x.x. Admission of Additional Members. The Members (upon a vote of Members holding two-thirds of the Percentage Interests) may admit additional Members to the Company upon those terms and conditions as the Members may determine. Any additional Members shall be granted Membership Interests and may participate in the Net Profits, Net Losses, Distributable Cash and other Distributions of the Company on those terms as the vote of Members holding two-thirds of the Percentage Interests may fix. This authority is subject to compliance with applicable law.

90. Withdrawal of Partners.

Address whether a partner is permitted to withdraw and under what circumstances. The applicable partnership statute might permit partners to withdraw their capital from the partnership in the absence of a special provision in your partnership agreement. This provision is typical for a partnership agreement:

Delaware limited liability company law provides:
§ 18-603. Resignation of member.
A member may resign from a limited liability company only at the time or upon the happening of events specified in a limited liability company agreement and in accordance with the limited liability company agreement. Notwithstanding anything to the contrary under applicable law, unless a limited liability company agreement provides otherwise, a member may not resign from a limited liability company prior to the dissolution and winding up of the limited liability company. Notwithstanding anything to the contrary under applicable law, a limited liability company agreement may provide that a limited liability company interest may not be assigned prior to the dissolution and winding up of the limited liability company.

(footnote continued on the next page)
Section x.x. Withdrawal of a Member. A Member is not permitted to withdraw or to resign from the Company without the consent of the Manager. A Member withdrawing or resigning from the Company without the consent of the Manager in violation of this Section x.x, shall forfeit his Voting Interest and Economic Interest without further compensation. In addition, the Member shall be liable to the Company and the other Members for all damages suffered by the Company and the other Members as a result of this withdrawal.

This is another possibility:

Section x.x. Withdrawal of a Member. Any Member may withdraw from the Company (at any time and for any reason) upon ten (10) days prior written notice to the other Members and Managers. Any withdrawal shall constitute a Membership Termination Event and shall be subject to Article X.

91. Partner Meetings.

Your partnership agreement should address partner meetings (including call for meetings, quorums, what may be considered at a meeting, voting rights, proxies, and whether a partner may attend by telephone). Address whether unless otherwise provided in a limited liability company agreement, a limited liability company whose original certificate of formation was filed with the Secretary of State and effective on or prior to July 31, 1996, shall continue to be governed by this section as in effect on July 31, 1996, and shall not be governed by this section.

Delaware Limited Liability Company Act § 18-603. Delaware limited liability company law provides:

§ 18-604. Distribution upon resignation.

Except as provided in this subchapter, upon resignation any resigning member is entitled to receive any distribution to which such member is entitled under a limited liability company agreement and, if not otherwise provided in a limited liability company agreement, such member is entitled to receive, within a reasonable time after resignation, the fair value of such member’s limited liability company interest as of the date of resignation based upon such member’s right to share in distributions from the limited liability company.

Delaware Limited Liability Company Act § 18-604. Delaware Limited Liability Company Act provides:

§ 18-404. Classes and voting.

(footnote continued on the next page)
(a) A limited liability company agreement may provide for classes or groups of managers having such relative rights, powers and duties as the limited liability company agreement may provide, and may make provision for the future creation in the manner provided in the limited liability company agreement of additional classes or groups of managers having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of managers. A limited liability company agreement may provide for the taking of an action, including the amendment of the limited liability company agreement, without the vote or approval of any manager or class or group of managers, including an action to create under the provisions of the limited liability company agreement a class or group of limited liability company interests that was not previously outstanding.

(b) A limited liability company agreement may grant to all or certain identified managers or a specified class or group of the managers the right to vote, separately or with all or any class or group of managers or members, on any matter. Voting by managers may be on a per capita, number, financial interest, class, group or any other basis.

(c) A limited liability company agreement may set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any manager or class or group of managers, waiver of any such notice, action by consent without a meeting, the establishment of a record date, quorum requirements, voting in person or by proxy, or any other matter with respect to the exercise of any such right to vote.

(d) Unless otherwise provided in a limited liability company agreement, on any matter that is to be voted on, consented to or approved by managers, the managers may take such action without a meeting, without prior notice and without a vote if a consent or consents in writing, setting forth the action so taken, shall be signed by the managers having not less than the minimum number of votes that would be necessary to authorize or take such action at a meeting at which all managers entitled to vote thereon were present and voted. Unless otherwise provided in a limited liability company agreement, on any matter that is to be voted on by managers, the managers may vote in person or by proxy, and such proxy may be granted in writing, by means of electronic transmission or as otherwise permitted by applicable law. Unless otherwise provided in a limited liability company agreement, a consent transmitted by electronic transmission by a manager or by a person or persons authorized to act for a manager shall be deemed to be written and signed for purposes of this subsection. For pur-
partners can adopt resolutions by written consent. This is a short-form provision concerning partner meetings:

Section x.x. Meetings of Members; Written Consent.

(a) Meeting of Members.

(i) Meetings of the Members shall be held at those times as the Manager fixes. Meetings shall also be called upon the written demand of Members holding more than 30% of all Voting Interests. These meetings may address any matters on which the Members may vote. All meetings of the Members shall be held at the principal executive office of the Company or at such other location as may be designated by the Manager.

(ii) If a meeting of the Members is called, the Manager shall give written notice of the meeting to all Members. The Manager shall give written notice of the meeting not less than ten (10) calendar days (or more than thirty (30) calendar days) prior to the date of the meeting to all Members entitled to vote at the meeting. The notice shall state the place, date, and hour of the meeting and the general nature of business to be transacted. No other business may be transacted at the meeting.

(iii) No annual or regular meetings of Members are required. If annual or regular meetings are held, they shall be noticed, held and conducted under the Act.

(iv) A Majority in Interest of the Members (represented in person or by Proxy) shall constitute a quorum of the Members for the transaction of business at a meeting. Except to the extent that this Agreement expressly requires the approval of all of the Members, every act or decision done or made by a Majority in Interest of the Members present (in person or by Proxy) at a meeting duly held at which a quorum is present shall be the act of the Members and of the Company. At all meetings of Members, a Member may vote in person or by Proxy. Any Proxy shall be filed with the Manager before or at the time of the meeting and may be filed by facsimile transmission to the Manager at the principal executive office of the Company or at such other address as may be given by the Manager to the Members for these purposes. Members may participate in

poses of this subsection, the term “electronic transmission” means any form of communication not directly involving the physical transmission of paper that creates a record that may be retained, retrieved and reviewed by a recipient thereof and that may be directly reproduced in paper form by such a recipient through an automated process.
any meeting through the use of conference telephones or similar communications equipment as long as all Members participating can hear one another. A Member so participating is treated as present in person at the meeting.

(v) A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of Members if any action taken is approved by at least a Majority in Interest of the required quorum for the meeting.

(vi) Notwithstanding any provision of this Agreement to the contrary, however, whenever a Member is prohibited under this Agreement from voting on any matter, the applicable voting and quorum requirements shall be determined assuming that the Membership Interests held by the Member so disabled from voting were not issued or outstanding.

(vii) The transactions of any meeting of Members (however called and noticed and wherever held) shall be as valid as though consummated at a meeting duly held after regular call and notice, if (1) a quorum is present at that meeting, either in person or by Proxy, and (2) either before or after the meeting each of the Persons entitled to vote, not present in person or by Proxy, signs either a written waiver of notice, a consent to the holding of the meeting or an approval of the minutes of the meeting. Attendance of a Member at a meeting shall constitute waiver of notice unless that Member objects (at the beginning of the meeting) to the transaction of any business on the ground that the meeting was not lawfully called or convened. Attendance at a meeting is not a waiver of any right to object to the consideration of matters required to be described in the notice of the meeting and not so included, if the objection is expressly made at the meeting.

(viii) This Section x.x(a) govern meetings of the Members of the Company if the Manager or Members elect (in their sole and absolute discretion) to hold these meetings. However, nothing in this Section x.x(a) or in this Agreement is intended to require that meetings of the Members be held. Meetings of the Members are not required.

(b) Written Consent. Any action that may be taken by the Members at a meeting may also be taken without a meeting, if a consent in writing setting forth the action so taken is signed by Members having not less than the minimum votes that would be necessary to authorize that action at a meeting of the Members duly called and noticed at which all Members entitled to vote were present.
92. **Management.**

Partnership agreements may have simple or elaborate management provisions. Partnerships may have managers, general partners, or management committees. Some partnerships have different series of assets with different managers for each series.\(^{748}\)

The management provision should set forth a clear management structure and the powers of the managers or management committee. Just as important, the management provision should clarify limitations on the powers of the managers or management committee. This should include selection, removal, and replacement of managers or members of the management committee. (There may be a statutory right to remove a manager or a general partner in the absence of a provision to the contrary in your partnership agreement.) The management provision should clearly identify the manager’s standard of discretion in exercising management power. Your partnership agreement should clarify the manager’s ability to delegate duties.

The management provisions in this section should give you some ideas in drafting a management provision for your partnership, but you should use them merely as guidelines. The management provisions should be conformed to your particular circumstances. As is true with all provisions in your partnership agreement, the management provisions are not “boilerplate.” They are the heart and soul of the partnership.

---

\(^{748}\) Delaware Limited Liability Company Act § 18-402 ("Unless otherwise provided in a limited liability company agreement, the management of a limited liability company shall be vested in its members in proportion to then current percentage or other interest of members in the profits of the limited liability company owned by all of the members, the decision of members owning more than 50 percent of the said percentage or other interest in the profits controlling; provided however, that if a limited liability company agreement provides for the management, in whole or in part, of a limited liability company by a manager, the management of the limited liability company, to the extent so provided, shall be vested in the manager who shall be chosen in the manner provided in the limited liability company agreement. The manager shall also hold the offices and have the responsibilities accorded to the manager by or in the manner provided in a limited liability company agreement. Subject to § 18-602 of this title, a manager shall cease to be a manager as provided in a limited liability company agreement. A limited liability company may have more than 1 manager. Unless otherwise provided in a limited liability company agreement, each member and manager has the authority to bind the limited liability company.").
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

A simple management provision for a limited liability company might include these terms:

Section x.1. Management of the Company by the Managers.

(a) Exclusive Management by the Managers.

(i) The business, property and affairs of the Company shall be managed exclusively by the Managers.

(ii) Except for matters as to which the approval of the Members is expressly required by the Act or Section x.3, the Managers have full, complete and exclusive authority, power and discretion to manage and to control the business, property and affairs of the Company, to make all decisions regarding those matters, to supervise, to direct and to control the actions of the officers (if any) of the Company, and to perform any and all other actions customary or incident to the management of the Company’s business, property and affairs.

(iii) The Members have no power to participate in the management of the Company (except as expressly authorized by this Agreement and except as expressly required by any non-waivable provision of the Act).

(iv) Without the written authorization of the Managers to do so, no Member has any power or authority to bind or act on behalf of the Company in any way, to pledge its assets, or to render it liable for any purpose.

(v) If any Manager acquires a Membership Interest as a Member, then (in addition to his rights and liabilities as a Manager) the Manager shall have all of the rights and liabilities of a Member as provided by law and in this Agreement. This includes (without prejudice to generality) the right to allocations of Net Profits, Net Losses and Distributions.

(b) Powers of the Managers. Without prejudice to the generality of the foregoing, the Managers (acting alone and without obtaining any approval from the Members except only as required in Section x.3 or the Act) have the exclusive power to cause the Company:749

---

749 Some draftsmen believe that it is unnecessary to enumerate specific powers of the manager after the partnership agreement has stated that the manager “have full, complete and exclusive authority, power and discretion to manage and to control the business, property and affairs of the Company.” This may be an ap-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(i) To do any act in the conduct of its business and to exercise all powers granted to a limited liability company under the Act, whether in the State of Texas or in any other state, territory, district or possession of the United States or any foreign country, that may be necessary, convenient, desirable or incidental to the accomplishment of the business purposes of the Company.

(ii) To make any expenditures, to lend or to borrow money and to incur any obligations the Managers deem necessary for the conduct of the activities of the Company. This includes (without prejudice to generality) the right to make prepayments on loans and to borrow money or to sell assets to permit the Company to make distributions to its Members, to assume or guarantee, or contract for, indebtedness and other liabilities, to issue evidences of indebtedness, and the securing of these borrowings by deed, mortgage, deed of trust or other lien or encumbrance on the Company’s assets.

(iii) To employ, to engage, to retain or to deal with those contractors, subcontractors, designers, managers, accountants, lawyers and/or other Persons (including (without prejudice to generality) the Managers) (in accordance with the limitations set forth in Section y.y), in any capacities as independent contractors, agents or employees of the Company, that the Managers may determine necessary or appropriate in their absolute judgment for the proper operation of the business of the Company, and to delegate all or any part of their duties under this Agreement, and in furtherance of any delegation to employ, to engage and to retain any Person whom they (in their sole and absolute discretion) may deem necessary or desirable to perform the administrative or managerial functions necessary to the management of the Company (as may be agreed upon with the Managers). The Company may pay or reimburse any Person providing services for the Company for his traveling and incidental expenses or any salary or other compensation to this Person (whether as an absolute obligation or as a deferment). The fact that a Member is employed by (or is directly or indirectly related to or affiliated with) any such Person shall not prohibit the Managers from employing or otherwise dealing with this Person.

(iv) To negotiate, to execute, and to perform any contracts, leases, conveyances or other instruments that the Managers (is

appropriate observation. Other draftsmen prefer also to enumerate specific power so that banks, insurance companies, and other third parties will be comfortable that specific actions are authorized.
their sole and absolute discretion) consider useful or necessary to the conduct of the Company’s operations or the implementation of the Managers’ powers under this Agreement which agreements may contain those terms, provisions and conditions as the Managers (in their sole and absolute discretion) shall approve. This includes (without prejudice to generality) the power to contract with contractors, developers, consultants, accountants, legal counsel, other professional advisors and other agents.

(iv) To purchase from others (at the expense of the Company) contracts of liability, casualty, errors and omissions and other insurance and bonds that the Managers deem advisable, appropriate or convenient for the protection of the properties or affairs of the Company or for any other purpose convenient or beneficial to the Company (as determined in the sole and absolute discretion of the Managers).

(v) To acquire, to own, to hold, to operate, to maintain, to finance, to refinance, to improve, to lease, to sell, to convey, to mortgage, to transfer, to demolish or to dispose of any asset as may be necessary, convenient, desirable or incidental to the accomplishment of the business purposes of the Company or to merge, consolidate, to enter a reorganization or other combination of the Company with or into another entity (all of the foregoing subject to any prior approval only to the extent required by Section x.x of this Agreement). This includes (without prejudice to generality) the power to exercise or to grant any conversion, option, privilege or subscription right or any other right available in connection with any assets at any time held by the Company.

(vi) To enter into, to perform and to carry out any contracts, leases, instruments, commitments, agreements or other documents of any kind. This includes (without prejudice to generality) contracts with any Member or Manager, any Affiliate thereof or any agent of the Company, necessary, convenient, desirable or incidental to the accomplishment of the business purposes of the Company.

(vii) To sue and to be sued, to complain and to defend and to participate in administrative or other proceedings (all in the name of the Company).

(vii) To appoint officers, employees and agents of the Company, to define their duties and to fix their compensation (if any) and to select attorneys, accountants, consultants and other advisors of the Company.

(ix) To indemnify any Person in accordance with the Act and to obtain any and all types of insurance.
THE COMPANY, the partnership or the LLC.

To negotiate, to enter into, to renegotiate, to extend, to renew, to terminate, to modify, to waive, to execute, to acknowledge or to take any other action with respect to any loan agreement, commitment, deed of trust, mortgage, security agreement or other loan document in respect of any assets of the Company.

To pay, to collect, to compromise, to litigate, to arbitrate or otherwise to adjust or to settle any and all other claims or demands of or against the Company or to hold proceeds as reserves against the payment of contingent liabilities.

To make, to execute, to acknowledge, to endorse and to file any and all agreements, documents, instruments, checks, drafts or other evidences of indebtedness necessary, convenient, desirable or incidental to accomplish the business purposes of the Company.

To cease the Company’s activities and to dissolve and to wind up its affairs upon its duly authorized dissolution.

Subject to this Agreement, to make tax, regulatory and other filings, or render periodic or other reports to governmental or other agencies having jurisdiction over the business or assets of the Company. This includes (without prejudice to generality) the registration of any class of securities of the Company under the Exchange Act and the listing of any debt securities of the Company on any exchange.

To manage, to operate, to lease, to landscape, to repair, to alter, to demolish or to improve any real property or improvements owned by the Company or any Subsidiary of the Company.

To distribute Company cash or other Company assets in accordance with this Agreement.

To hold, to manage, to invest, and to reinvest cash and other assets of the Company.

To collect and to receive revenues and income of the Company.

To establish one (1) or more divisions of the Company, to select and to dismiss employees of the Company (including (without prejudice to generality) employees having titles such as “president,” “vice president,” “secretary” and “treasurer” of the Company), and agents, outside attorneys, accountants, consultants and contractors of the Company, and to determine of their compensation and other terms of employment or hiring.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(xxi) To maintain insurance for the benefit of the Company, the Managers and directors and officers of the Company as it deems necessary or appropriate.

(xxii) To form or to acquire interests in (and to contribute property to) any limited or general partnerships, limited liability companies, joint ventures or other relationships that the Managers deem desirable. This includes (without prejudice to generality) the acquisition of interests in (and the contributions of property to) any Subsidiary and any other Person in which it has an equity investment.

(xxiii) To control any matters affecting the rights and obligations of the Company. These matters include (without prejudice to generality) the settlement, compromise, submission to arbitration or any other form of dispute resolution, or abandonment of, any claim, cause of action, liability, debt or damages, due or owing to or from the Company, the commencement or defense of suits, legal proceedings, administrative proceedings, arbitration or other forms of dispute resolution, and the representation of the Company in all suits or legal proceedings, administrative proceedings, arbitrations or other forms of dispute resolution, the incurring of legal expense, and the indemnification of any Person against liabilities and contingencies to the extent permitted by law.

(xxiv) To undertake and to control any action in connection with the Company’s direct or indirect investment in any Subsidiary or any other Person. This includes (without prejudice to generality) the contribution or loan of funds by the Company to the Person.

(xxv) To determine the fair market value of any Company property distributed in kind using any reasonable method of valuation as the Managers may adopt.

(xxvi) To enforce any rights against any Member pursuant to representations, warranties, covenants and indemnities relating to the Member’s contribution of property or assets to the Company.

(xxvii) To exercise (directly or indirectly) through any attorney-in-fact acting under a general or limited power of attorney, any right. This includes (without prejudice to generality) the right to vote appurtenant to any asset or investment held by the Company.

(xxviii) To exercise any of the powers of the Managers enumerated in this Agreement on behalf of or in connection with any Subsidiary of the Company or any other Person in which the Company has a direct or indirect interest, or jointly with any Subsidiary or other Person.
(xxix) To exercise any of the powers of the Managers enumerated in this Agreement on behalf of any Person in which the Company does not have an interest under contractual or other arrangements with this Person.

(xx) To make, to execute and to deliver any and all deeds, leases, notes, mortgages, deeds of trust, security agreements, conveyances, contracts, guarantees, warranties, indemnities, waivers, releases or legal instruments or agreements in writing necessary or appropriate, in the judgment of the Managers (in their sole and absolute discretion) for the accomplishment of any of the powers of the Managers enumerated in this Agreement.

(xiv) To cause any special purpose subsidiary limited liability company wholly owned by the Company to do any of the foregoing.

(xxi) To issue additional Company Units (as appropriate and in the Managers’ sole and absolute discretion) in connection with Capital Contributions made by Additional Members and additional Capital Contributions by Members under Article X of this Agreement.

(c) Agency Authority of the Managers; Delegation by the Managers. Each Manager (acting alone) is authorized to endorse all checks, drafts and other evidences of indebtedness made payable to the order of the Company. Each Manager (acting alone) is authorized to execute all agreements, contracts, commitments, checks, instruments and other documents on behalf of the Company. The Managers may also delegate any or all of their authority, rights and/or obligations (whether arising under this Agreement, under the Act or otherwise), to any one or more officers, agents or other duly authorized representatives of the Company.

(d) Discretion of the Managers. In making any and all decisions relating to the conduct of the Company’s business or otherwise delegated to them by any provision of this Agreement, the Managers shall be free to exercise their sole and absolute discretion. The Managers shall not (in respect of this decision) be liable to the Company, the Members or any of their respective Affiliates or constituent owners for any resulting actual or alleged losses, damages, costs or expenses suffered by them so long as this decision was made by the Managers in good faith for a purpose reasonably believed by them to be in (or not opposed to) the best interests of the Company.

(e) Performance of Duties; Liability of Managers. The Managers shall perform their managerial duties in good faith and in a manner they believe to be in (or not opposed to) the best interests of the Company. In performing their duties, the Managers may rely on information, opin-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ions, reports or statements (including (without prejudice to generality) financial statements and other financial data) of any attorney, independent accountant or other Person as to matters that the Managers believe to be within that Person’s professional or expert competence unless the Managers have actual knowledge concerning the matter in question that would cause reliance to be unwarranted.

(f) Devotion of Time. The Managers shall not be obligated to devote all of their time or business efforts to the affairs of the Company. The Managers shall devote such time, effort and skill as they deem appropriate for the management and operation of the Company’s affairs.

(g) Decisions of the Managers. Any decision or action taken by a majority (in number) of the Managers (whether verbal or in writing, whether in person or by proxy and whether or not at a formal meeting called under Section x.1(h)) shall constitute the act or decision of the Managers. The Managers may delegate to any one or more Managers (acting alone) the authority to make any specific decisions.

(h) Meetings of Managers. Meetings of the Managers may be called by any Manager or by the Chairperson, President, any Senior Vice-President or Vice-President or the Secretary of the Company (if any). All meetings shall be held upon five (5) Business Days’ notice by mail or forty-eight (48) hours notice delivered personally or by telephone, telegraph or facsimile. The notice shall be treated as having been given upon depositing the notice in the United States mail. A notice need not specify the purpose of any meeting. Notice of a meeting need not be given to any Manager who signs a waiver of notice, a consent to holding the meeting or an approval of the minutes thereof, whether before or after the meeting, or who attends the meeting (whether in person, by telephone, by proxy or otherwise) without protesting the lack of notice prior to the commencement of the meeting. All waivers, consents and approvals shall be filed with the Company records or made a part of the minutes of the meeting. A majority of the authorized number of Managers constitutes a quorum of the Managers for the transaction of business. Except to the extent that this Agreement expressly requires the approval of all of the Managers, every act or decision done or made by a majority of the Managers present at a meeting duly held at which a quorum is present is the act of the Managers. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of Managers if any action taken is approved by at least a majority of the required quorum for the meeting. Managers may participate in any meeting of the Managers by means of conference telephones or similar communications equipment so long as all Managers participating can hear one another. A Manager so participating
is treated as present at the meeting. This Section x.1(h) governs meetings of the Managers if the Managers elect (in their sole and absolute discretion) to hold meetings. However, nothing in this Section x.1(h) or in this Agreement is intended to require that meetings of the Managers be held. Meetings of the Managers are not required.

Section x.2. Election of Managers.

(a) Number and Term. The Company shall initially have *** Managers. The initial Managers shall be *****. The number of Managers of the Company may be increased or decreased only by the affirmative vote or written consent of a Majority in Interest of the Members. Each Manager shall hold office indefinitely, unless that Manager resigns, dies or is removed.

(b) Removal. Any Manager may be removed at any time (but only for Cause) by the affirmative vote or written consent of the other Managers. For purposes of the preceding sentence, “cause” is defined as —

(i) The Manager’s failure (by reason of physical or mental impairment) substantially to perform the material duties of the Manager for a period of sixty (60) consecutive days or one hundred twenty (120) days in a three hundred sixty-five (365) day period, 

(ii) The Manager’s intentional or reckless disregard of material duties, 

(iii) The Manager’s commission of a felony (whether or not involving moral turpitude) or a misdemeanor (involving moral turpitude). 

(iv) The Manager’s commission of any misdemeanor (whether or not involving moral turpitude) involving the business of the Company. 

(v) The Manager’s commission of an act of fraud or dishonesty with respect to the Manager’s duties under this Agreement. 

(vi) The Manager’s material breach of a provision of this Agreement. 

(vi) The Manager’s failure to make a Capital Contribution pursuant to a Call; or 

(vii) The Manager’s breach of another provision of this Agreement that has (or can reasonably be expected to have) a material adverse effect on the Company that cannot be cured or that is not cured within thirty (30) days after notice thereof from a Member.
For purposes of this Section x.2(b), “commission” shall include (without prejudice to generality) the Manager’s being charged by indictment or information, or the Manager’s being convicted (including (without prejudice to generality) by entry of a plea of guilty or nolo contendere).

(c) Vacancies. Any vacancy occurring for any reason in the number of Managers may be filled by the affirmative vote or written consent of a majority (in number) of the other Managers.

Section x.3. Limitations on Power of the Managers. Notwithstanding any other provisions of this Agreement, the Manager shall not undertake any Major Decision without the consent of a Majority in Interest of the Members.

Section x.4 Transactions Between the Company and the Managers, the Members or their Affiliates.

(a) Contracts with Affiliates. The Managers may engage (and may cause their Affiliates to engage) in any transaction with the Company. Any such transaction shall be upon terms and conditions substantially equivalent to those that could be obtained by the Company in bona fide arms-length agreements under comparable circumstances between the Company and reputable, financially responsible third parties and not otherwise expressly prohibited by this Agreement. For this purpose, “transaction” includes (without prejudice to generality) the purchase, sale, lease or exchange of any property, the lending of money, the rendering of any service or the establishment of any salary, other compensation or other terms of employment.

(b) Contracts with Affiliates of the Managers. The Members acknowledge and intend that the Managers may provide (or cause the Company to engage one or more of its Affiliates to provide) any or all goods and/or services required by the Company in the conduct of its business. This provision shall be made upon terms and conditions substantially equivalent to those that could be obtained by the Company in bona fide arms-length agreements under comparable circumstances between the Company and reputable, financially responsible third parties and not otherwise expressly prohibited by this Agreement.

(c) Treatment of Affiliate Loans and Fees. To the fullest extent permitted by law, all principal, interest, costs and expenses owing by the Company to the Members, the Managers and/or Affiliates thereof in repayment of loans and all fees, commissions and/or reimbursable amounts payable by the Company to the Members, the Managers and/or Affiliates thereof shall be treated in the same manner as liabilities payable to unaf-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

filiated creditors of the Company. These obligations shall be paid before
any Distributions of Distributable Cash are made to the Members.

Section x.5. Officers.

(a) Appointment of Officers. The Managers (at their sole and
absolute discretion) may appoint officers of the Company at any time to
conduct, or to assist the Managers in the conduct of, the day-to-day busi-
ness and affairs of the Company. The officers of the Company may include
a Chairperson, a President or Chief Executive Officer, one or more Senior
Vice Presidents, one or more Vice Presidents, a Secretary, one or more
Assistant Secretaries, a Chief Financial Officer, a Treasurer, one or more
Assistant Treasurers and a Comptroller. The officers shall serve at the
pleasure of the Managers, subject to all rights (if any) of an officer under
any contract of employment. Any individual may hold any number of offic-
es. Officers of the Managers (if one or more Managers are entities) may
serve as officers of the Company if appointed by the Managers. If any offi-
cer is entitled to a salary for his services, however, all of that salary
shall be paid by the Managers and not by the Company. The officers of the
Company shall exercise those powers and perform any duties as are typi-
cally exercised by similarly titled officers in a corporation or as deter-
dined by the Managers but subject in all cases to the supervision and con-
trol of the Managers.

(b) Signing Authority of Officers. The officers (if any) have any
authority to sign checks, instruments and other documents on behalf of the
Company as may be delegated to them by the Managers.

(c) Acts of Officers as Conclusive Evidence of Authority. Any
note, mortgage, deed of trust, evidence of indebtedness, contract, certifi-
cate, statement, conveyance or other instrument or obligation in writing,
and any assignment or endorsement thereof, executed or entered into be-
tween the Company and any other Person, when signed by (i) the Chair-
person, the President or Chief Executive Officer, any Senior Vice-
President or by any Vice-President and (ii) the Chief Financial Officer,
any Secretary, any Assistant Secretary, any Treasurer, or any Assistant
Treasurer of the Company, is not invalidated as to the Company by any
lack of authority of the signing officers in the absence of actual knowledge
on the part of the other Person that the signing officer(s) had no authority
to execute these instruments or documents.
Section x.6. No Management Fee. The Managers shall not be entitled to any management fee or other compensation for their services as Managers.

(a) Services Performed by Members, Economic Interest Holders or Affiliates. The Company shall pay the Members and their Affiliates for services rendered or goods provided by them to the Company to the extent that (i) those Members or Affiliates are not required to render these services or goods themselves without charge to the Company, and (ii) the fees paid to those Members or Affiliates do not exceed the fees that would be payable to independent responsible third parties that are willing to perform those services or provide those goods.

(b) Expenses. The Company shall reimburse the Managers and their Affiliates for all reasonable out-of-pocket costs and expenses incurred by them in connection with the business and affairs of the Company. The Company shall reimburse the Managers and their Affiliates for all reasonable organizational expenses incurred by them to form the Company and prepare the Certificate of Formation and this Agreement. These expenses include (without prejudice to generality) legal and accounting fees and costs. The Managers may allocate to the Company (on any basis selected by them in good faith that is consistent with good accounting practice) a portion of any and all expenses incurred by them or their Affiliates for the mutual benefit of the Company and other Persons. These expenses include including (without prejudice to generality) general, special and administrative expenses.

Many partnership agreements manage through a management committee to which different partners nominate representatives. This is a common provision for a simple management committee:

Section x.x Management Committee.

x.x.1 Management by the Management Committee. The Company shall be managed by the Members acting through a management committee (the “Management Committee”). The Management Committee shall be responsible for establishing the policies and procedures to be followed by the Company. The Management Committee shall take such actions (other than day-to-day management activities) as are reasonably necessary for the Company to carry out its purpose under this Agreement.

x.x.2 Composition of the Management Committee.

The Management Committee shall initially be composed of three (3) representatives (individually, a “Management Committee Representative” and, collectively, the “Management Committee Representatives”). Each Member shall appoint one (1) Management Committee Representa-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tive. **** appoints **** as its initial Management Committee Representative; **** appoints **** as its initial Management Committee Representative; and **** appoints ***** as its initial Management Committee Representative.

If any Management Committee Representative ceases to serve for any reason, then the Member that appointed that Management Committee Representative shall replace that Management Committee Representative with a new Management Committee Representative selected in the sole and absolute discretion of the Member by giving written notice of this selection to the other Members. The other Members do not have any right to approve any replacement Management Committee Representative.

The authorized number of Management Committee Representatives of the Management Committee may be increased or decreased only with prior written approval of all of the Members.

Any other persons affiliated with (and designated by) a Member has the right to attend and to participate in meetings of the Management Committee as non-voting participants.

x.x.3 Management Committee Procedures.

(a) Decisions of the Management Committee.

Subject to Section x.x.4 below, all decisions by the Management Committee shall require the approval by Majority Vote of the Management Committee Representatives. The immediately previous sentence is qualified by the requirement that only the Management Committee Representatives designated by the non-interested Member(s) may vote on any matter in which a Member has a conflict of interest or any other interest not arising solely as a result of its being a Member.

(b) Meetings. The Management Committee shall meet at such times and places and call and conduct its meetings pursuant to those procedures that the Management Committee establishes.

(c) Limitations on Authority. None of the Members, Management Committee Representatives or officers (without prior written consent of all of the Members) may take any action on behalf of or in the name of the Company, or enter into any commitment or obligation binding upon the Company, except for –

(i) Actions expressly authorized by this Agreement;

(ii) Actions by any Member, Management Committee Representative or officer within the scope of the Member’s,
Management Committee Representative’s or officer’s authority granted under this Agreement; and

(iii) Actions authorized by the Management Committee in the manner set forth in this Agreement.

Each Member shall indemnify, defend, protect and hold wholly free and harmless the Company and the other Members, from and against any loss, liability, claim, damage or expense arising out of any breach of the foregoing provisions of this Section x.x.3(c) by the Member or the Member’s Management Committee Representative, employees, agents or Affiliates.

(d) Involvement of the Representatives. Each Member shall cause its Management Committee Representative to be actively involved in the business of the Company and to devote such time as is reasonably necessary to carry out his duties and obligations as a Management Committee Representative.

x.x.4 Major Decisions. Major Decisions Requiring Unanimous Consent of the Management Committee Representatives. Notwithstanding anything to the contrary stated in this Agreement, neither the Manager nor any other Member has authority to do any of these acts with respect to the assets or business of the Company or any Project unless approved by the Unanimous Consent of the Management Committee Representatives (and the approval (to the extent required) of any lender to the Company) [Note: Consider modifications to reconcile this provision with the powers of the Liquidator upon Liquidation.]:

(a) To cause or to permit the Company to obtain or to modify any loan in a manner that would result in or increase the liability of any Member or its Affiliate under any guaranty or indemnity issued by that Member or Affiliate.

(b) To cause or to permit any Member or Affiliate to execute any guaranty or indemnity agreement relating to a Project (other than a guaranty or indemnity agreement approved in writing by all of the Members).

(c) Voluntarily to cause or to permit (directly or indirectly) the Company to take any action that would constitute an act of Bankruptcy that would increase the risk of liability to any Member or its Affiliates under any guaranty or indemnity issued by that Member or Affiliate.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(d) To cause or to permit the Company to acquire any asset not within the scope of the Company’s purpose or otherwise not related to a Project.

(e) To cause or to permit the Company to take any action that would impose personal liability on a Member for any obligation or liability of the Company.

(f) To cause or to permit the Company to take any action in contravention of this Agreement. This includes (without prejudice to generality) the acceptance of additional Capital Contributions or loans from Members or permitting the Transfer of any interest in the Company not expressly provided for in this Agreement.

(g) To cause or to permit the Company (a) to be merged with any other Entity or (b) to undertake any action that would cause the Company to become an entity other than a Delaware limited liability company.

(h) To cause or to permit the Company to change its purpose or the scope of its business.

(i) To cause or to permit the Company to dissolve, to terminate or to liquidate or to redeem the interest of any Member in the Company (except in accordance with this Agreement).

(j) To cause or to permit the Company to admit any new Members or to issue or sell any additional Membership Interests.

(k) To cause or to permit the Company to amend this Agreement (unless the amendment has been approved in writing by all Members).

(l) To sell (or to contract to sell) any of the Projects.

(m) To make a distribution to a Member of property in-kind (other than money).

(n) To amend the terms of this Agreement.

This is another simple provision for a partnership that is managed by a management committee:

x.1. Management Committee.

Except as otherwise provided in this Agreement, all aspects of the business and affairs of the Partnership (including acts performed by the Partnership on behalf of Subsidiary Partnerships and Special Purpose Entities) shall be managed, and all decisions affecting the business and affairs of the Partnership shall be made, by the General Partner, in certain
cases described herein, acting through a management committee (the “Management Committee”).

Each of the Management Committee and the General Partner may delegate its authority to a General Manager (as further provided in Section x.3 below).

The Management Committee shall be composed of three (3) representatives and shall act in accordance with the following rules:

(a) Representatives.

The General Partner shall be entitled to select two (2) representatives on the Management Committee.

***** shall be entitled to select one (1) representative on the Management Committee.

The General Partner hereby designates ***** and ***** as its initial representatives on the Management Committee.

***** hereby designates ***** as its initial representative on the Management Committee.

Each representative shall serve until removed by the appointing Partner or until the representative resigns.

Each appointing Partner may (from time to time) change its respective designated representative(s) on the Management Committee by giving written notice of this change to the other appointing Partner.

All vacancies on the Management Committee shall be filled within thirty (30) days.

The Management Committee shall have the authority to make all decisions affecting the business and affairs of the Partnership as fully and completely as if the General Partner was itself making this decisions.

(b) Number. Except as otherwise provided by this Agreement, the number of representatives of the Management Committee may be increased or decreased from time to time by the Management Committee so long as there is a two (2) to one (1) ratio between the number of representatives designated by ***** and ***** respectively.

(c) Meetings. Regular meetings of the Management Committee shall be held at the principal office of the Partnership (or at this other place(s) as are designated by the Management Committee) at such times as shall be designated by the Management Committee. The Management Committee shall use reasonable efforts to meet no less frequently than annually.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(d) Special Meetings. Special meetings of the Management Committee may be called by or at the request of any representative. Special meetings shall be held at the principal office of the Partnership (or at such other place(s) as may be designated by the Management Committee). The person(s) authorized to call any special meeting of the Management Committee may designate any reasonable time for holding of the special meeting.

(e) Telephonic Participation. Representatives of the Management Committee may participate in any regularly scheduled or special meetings of the Management Committee telephonically or through other similar communications equipment, as long as all of the representatives participating in the meeting can hear one another. Participation in a meeting pursuant to the preceding sentence shall constitute presence in person at this meeting for all purposes of this Agreement.

(f) Proxies.

Every representative of the Management Committee entitled to vote or to act on any matter at a meeting of the Management Committee shall have the right to do so either in person or by proxy.

An instrument authorizing a proxy to act must be executed by the representative of the Management Committee in writing and dated not more than twelve (12) months before the meeting.

A proxy shall be deemed executed by a representative of the Management Committee if the representative’s name is placed on the proxy by the representative of the Management Committee or the representative’s attorney-in-fact.

A proxy purporting to be executed by or on behalf of a representative of the Management Committee shall be deemed valid unless challenged at or prior to its exercise. The burden of proving invalidity shall rest on the challenger.

A valid proxy that does not state that it is irrevocable shall continue in full force and effect (subject to the twelve (12) month limit set forth above) unless revoked by the person who executed it (i) by delivering a writing to the Management Committee stating that the proxy is revoked before any vote pursuant to that proxy, (ii) by attendance at the meeting and voting in person by the person, or (iii) by written notice of the death or incapacity of the maker of that proxy received by the Management Committee before the vote pursuant to that proxy is counted.

( g ) Notice and Attendance.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Notice of any meeting of the Management Committee shall be given in writing no fewer than ten (10) days and no more than sixty (60) days prior to the date of the meeting.

The attendance of a representative of the Management Committee at a meeting of the Management Committee shall constitute a waiver of notice of this meeting, except where a representative of the Management Committee attends a meeting for the express purpose of objecting to the transaction of any business because the meeting is not properly called or convened.

Any representative who attends solely for purposes of objecting to the transaction of business shall not be entitled to vote on any other matter.

The business to be transacted at or the purpose of any regular or special meeting of the Management Committee shall be specified in the notice or waiver of notice of this meeting.

(h) Quorum. The presence (either in person, by proxy or by telephone) of all of the General Partner’s representatives on the Management Committee shall be necessary to constitute a quorum for the transaction of business at any meeting of the Management Committee; provided that, if less than all representatives of the Management Committee designated by the General Partner are present at this meeting, a majority of the General Partner’s representatives actually present may adjourn the meeting at any time without further notice.

(i) Decisions.

Each member of the Management Committee is entitled to cast one vote.

Provided that notice of a meeting has been given in the manner set forth in this Agreement and a quorum is present, and except as specifically required otherwise under this Agreement, the act of a majority (in number) of the representatives of the Management Committee shall be the act of the Management Committee and shall constitute a decision of the Management Committee.

This decision shall be binding upon the Partnership and on each Partner; provided, however, the majority (in number) vote shall be binding only if (i) in the case of a Major Decision, all of the representatives designated by the General Partner vote in favor of the Major Decision, or (ii) in the case of a decision other than a Major Decision, a majority of the representatives designated by the General Partner vote in favor of that other type of decision.
(k) Actions Without Meetings.

Any action required or permitted to be taken at a meeting of the Management Committee or any other action that may be taken at a meeting of the Management Committee may be taken without a meeting if a consent in writing (setting forth the actions so taken) shall be signed by all of the representatives of the Management Committee.

Any consent signed by all of the representatives of the Management Committee shall have the same effect as an act of the Management Committee at a properly called and constituted meeting of the Management Committee at which all of the representatives of the Management Committee were present and voting.

(l) Execution of Documents. Except as provided in Section x.3 below, all contracts, agreements and other documents or instruments affecting or relating to the business and affairs of the Partnership may be executed on the Partnership's behalf only by (i) the General Partner, or (ii) as specifically authorized in writing by the Management Committee, the General Manager, or other designated person(s). The signature of any one authorized person shall bind the Partnership.

(m) Unauthorized Actions. Neither the General Partner nor the General Manager (without the prior consent of the Management Committee) shall take any action on behalf of or in the name of the Partnership, or enter into any commitment or obligation binding upon the Partnership, except for (i) actions by the General Partner or the General Manager within the scope of the General Partner's or the General Manager's authority granted hereunder, and (ii) actions authorized by the Management Committee in the manner set forth herein.

x.2. Authority of the Management Committee; Authority of the General Partner.

(a) Authority of the Management Committee. Without limiting the generality of Section x.1, and except as otherwise provided by this Agreement (including, without prejudice to generality, subsection (b) of this Section x.2), a decision of the Management Committee shall be required for the Partnership to undertake (or for the Partnership to approve or to cause a Subsidiary Partnership or Special Purpose Entity to undertake) and the Management Committee shall have the exclusive right, power and authority to approve and to cause the Partnership to undertake (or to cause or to permit a Subsidiary Partnership or Special Purpose Entity to undertake) (to the extent permitted by its organizational agreements) all of the following:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(i) Initial Public Offerings. Any initial public offering of ownership interests in the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) (and in any corporation or other entity that is the successor to the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be));

(ii) Sale or Other Transfer. The sale, exchange, transfer or other disposition of all or any portion of the assets of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be);

(iii) Financing and Refinancing. The terms and conditions of any and all financing and refinancing for the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) and any modifications or amendments to the terms and conditions of financing or refinancing documents;

(iv) Material Corporate Transactions. The consummation of (or the entry into any agreement with respect to) any acquisition, disposition, merger, “roll-up” consolidation, reorganization, recapitalization, restructuring, joint venture, partnership, limited liability company or any other material corporate transaction involving the Partnership or any Subsidiary Partnership or Special Purpose Entity (as the case may be) or any of their respective assets; this includes, without prejudice to generality, any and all actions required and permitted in connection with any initial public offering of ownership interests in the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be); this also includes dispositions in connection with the merger or the transfer of the assets of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) to any corporation or other entity that is the successor to the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) that intends to conduct an initial public offering; further, this includes, without prejudice to generality, the valuation of any dissenter’s rights and any transfer of all or any portion of the assets of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) to a public or private market vehicle that intends to qualify as a real estate investment trust (“REIT”) under Section 856 et seq. of the Code or to a partnership, limited liability company or other entity whose general partner, managing member or other owner, intends to qualify as a REIT, or a transfer or all or any portion of the assets of the partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) to a comparable public or private REIT vehicle;

(v) Additional Capital Contributions. The requirement of any Additional Contributions to the capital of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) in accord-
ance with the provisions of Article IV; the Management Committee shall seek the advice and recommendation of the General Manager in determining the need to make Additional Contributions, and this determinations will be made in good faith by the Management Committee;

(vi) Liquidation of the Partnership or Subsidiary Partnerships or Special Purpose Entities. Except to the extent dissolution of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) is permitted or required by this Agreement or any applicable law which is not superseded by the provisions of this Agreement, the dissolution and winding up of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be);

(vii) Bankruptcy. Any of the following:

(i) the filing of any voluntary petition in bankruptcy on behalf of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be),

(ii) the consenting to the filing of any involuntary petition in bankruptcy against the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be),

(iii) the filing of any petition seeking, or consenting to, the reorganization or relief under any applicable federal or state law relating to bankruptcy or insolvency,

(iv) the consenting to the appointment of a receiver, liquidator, assignee, trustee, sequestrator (or other similar official) of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) or a substantial part of its property,

(v) the making of any assignment for the benefit of creditors,

(vi) the admission in writing of the Partnership’s or Subsidiary Partnerships’ or Special Purpose Entities’ (as the case may be) inability to pay its debts generally as they become due, or

(vii) the taking of any action by the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) in furtherance of any this action; and

(viii) Other Actions. Any and all other actions required or permitted to be taken by the Management Committee under this Agreement and any and all other actions relating to the business and affairs of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) that are necessary or advisable to carry out the forego-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

ing and (to the extent not inconsistent with any other provisions of this
Agreement) the intentions and purposes of the Partnership or Subsidiary
Partnerships or Special Purpose Entities (as the case may be).

(b) Authority of the General Partner. Anything to the contrary
in this Agreement notwithstanding (including, without prejudice to gener-
ality, any inconsistent or contrary provisions of subsection (a) of this Sec-
tion x.2), the General Partner’s prior written approval shall be required
for the Partnership to undertake (or for the Partnership to approve or to
cause a Subsidiary Partnership or Special Purpose Entity to undertake),
and the General Partner shall have the exclusive right, power and au-
thority to approve and to cause the Partnership to undertake (or to cause
or to permit a Subsidiary Partnership or Special Purpose Entity to unde-
take (to the extent permitted by its organizational agreements)), all of the
following:

(i) Sale or Other Transfer of Assets. The sale, exchange, trans-
fer or other disposition of all or any portion of any Assets of the Partne-
ship or Subsidiary Partnerships or Special Purpose Entities (as the case
may be);

(ii) Plans and Budgets. Subject to Section x.5 of this Agre-
ement, the approval of the Annual Business Plan and each Operating
Budget for the Partnership or Subsidiary Partnerships or Special Purpose
Entities (as the case may be) prepared by the General Manager;

(iii) Expenditures Outside of Plans or Budgets. The making of
any expenditure by the Partnership or Subsidiary Partnerships or Special
Purpose Entities (as the case may be) that is not specifically included or
contemplated under the Annual Business Plan or Operating Budgets, oth-
er than as permitted within any parameters agreed to by the General
Partner as set forth in Sections x.4 and x.5 of this Agreement (for example,
application of line item cost savings, contingency amounts, etc.);

(iv) Cash Flow and Reserves. The determination of any policies
and procedures with respect to distributions of Cash Flow From *****
Assets and Remaining Cash Flow pursuant to Sections *** and ***, respec-
tively, by the Partnership or Subsidiary Partnerships or Special Purpose
Entities (as the case may be) (including, without prejudice to generality,
the establishment of any reserves with respect thereto). This determination
shall be made in good faith by the General Partner;

(v) Material Agreements. The execution by the Partnership or
Subsidiary Partnerships or Special Purpose Entities (as the case may be)
of any material agreement in order to acquire, to operate, to manage, to
maintain, to market, to lease, to sell, to transfer, to convey, to exchange, to
pledge or otherwise to dispose of the assets of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) or any assets of the limited partnerships or other entities in which the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) are the general partner or member (including, without prejudice to generality, the Projects) and any undertaking by the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) to implement the terms of this Agreement (including, without prejudice to generality, the granting or withholding of approvals and consents);

(vi) Consultants. The employment and engagement of any agents, brokers, appraisers, architects, attorneys, accountants, bookkeepers, engineers, contractors, environmental consultants, real property and mortgage brokers and analysts, underwriters, escrow agents, depositaries, banks, managers, consultants and operators, marketing agents, property managers and any other service provider other than as permitted by the Management Agreement, the Construction Management Agreement, the applicable Annual Business Plan or Operating Budget, and not in the ordinary course of business;

(vii) Legal Proceedings. The institution of any legal proceedings (including, without prejudice to generality, arbitration) in the name of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be), settlement of any legal proceedings against the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be), and confession of any judgment against the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) or any property of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be); provided, however, that the General Manager (without the specific approval of the General Partner) may undertake eviction proceedings against tenants on behalf of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) and shall be permitted to file and to settle lawsuits on behalf of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) against third parties other than Partners or Affiliates in any instance in which the prayer for relief is less than $250,000;

(viii) Insurance. The entry by the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) into any and all contracts of insurance for the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) that the Management Committee deems necessary or proper for the protection of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) either for the conservation of its assets or for any purpose
 SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

convenient or beneficial to the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be);

(ix) Tax and Accounting Elections. Any and all tax and accounting elections permitted or required to be made by the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be);

(x) Transfers by Limited Partners. The approval of direct or indirect transfers of Limited Partner Interests pursuant to Section **; and

(xi) Other Actions. Any and all other actions required or permitted to be taken by the General Partner under this Agreement and any and all other actions relating to the business and affairs of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be) or necessary to carry out the intentions and purposes of the Partnership or Subsidiary Partnerships or Special Purpose Entities (as the case may be).

x.3. General Manager.

***** is hereby designated and hereby accepts appointment as the “General Manager” of the Partnership.

The General Manager shall be responsible for implementing the decisions of the Management Committee and the General Partner.

The General Manager also shall be responsible for regularly reporting to the Management Committee and the General Partner as to the status of the business and affairs of the Partnership, the Subsidiary Partnerships, and the Special Purpose Entities.

***** shall serve in this capacity as General Manager unless and until ***** is removed by the General Partner in accordance with the provisions of Section x.6 (or elsewhere in this Agreement) or resigns.

Following any removal of (or resignation by) ***** as the General Manager, the person or entity selected by the General Partner in accordance with the provisions of Section x.6 shall serve as the replacement General Manager of the Partnership.

The General Manager also shall be responsible for:

(a) advising the General Partner and the Management Committee on day-to-day matters affecting the business and affairs of the Partnership, the Subsidiary Partnerships and the Special Purpose Entities,

(b) diligently conducting the day-to-day operations of the Partnership, the Subsidiary Partnerships and the Special Purpose Entities using this General Manager’s reasonable commercial efforts to cause this
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

operations to be conducted in accordance with the applicable Annual Business Plan and Operating Budget (provided, that this "reasonable commercial efforts" shall not require the General Manager to spend any of its own funds),

(c) performing the duties assigned to this General Manager under this Agreement or by the General Partner or the Management Committee including, but not limited to, the hiring of staff and consultants required for this day-to-day operations, and

(d) diligently endeavoring to carry out all decisions and resolutions of the General Partner and the Management Committee (as applicable).

The General Manager at all times shall be subject to the direction and control of the General Partner and/or the Management Committee (as applicable).

The General Manager at all times shall conform to the policies and procedures established and approved by the General Partner.

The scope of the General Manager’s authority shall be limited solely to the matters set forth above in this Section x.3.

The General Manager’s authority shall not include the authority to undertake any of the actions in Section x.2 without express written delegation by the Management Committee.

The General Manager (using its reasonable judgment) shall keep the General Partner and/or the Management Committee (as applicable) informed as to all material matters of concern to the General Partner and/or the Management Committee.

The General Manager shall not be authorized to bind the Partnership, the Subsidiary Partnerships or the Special Purpose Entities without the prior written approval of the General Partner and/or the Management Committee (as applicable), except for

(a) matters delegated in writing to the General Manager by the General Partner and/or the Management Committee and

(b) any agreements, contracts or other documents or instruments limited to the day-to-day business and affairs of the Partnership (including, without prejudice to generality, property operating agreements and maintenance agreements); provided, however, that this agreement, contract or other document is within the parameters established in the applicable Annual Business Plan or Operating Budget and is terminable without penalty to the Partnership upon thirty (30) days’ notice.
***** shall receive no additional compensation for serving as General Manager.

x.4. Annual Business Plan.

On or before November 30 of each Fiscal Year of the Partnership, the Subsidiary Partnerships and the Special Purpose Entities, the General Manager will prepare and will submit an annual business plan ("Annual Business Plan") for the Partnership and each of the Subsidiary Partnerships and Special Purpose Entities for the ensuing Fiscal Year for the review and approval of the General Partner (or its designee).

The General Partner (or its designee) will use its reasonable commercial efforts to approve the Annual Business Plan no later than December 31 and to provide any specific objections prior to this date.

If the General Partner (or its designee) fails to approve the Annual Business Plan prior to December 31 of any given Fiscal Year, the Annual Business Plan for the next Fiscal Year (until the new Annual Business Plan is approved) shall be deemed to be equal to the prior Fiscal Year’s Annual Business Plan (increased for taxes and items provided for in any agreements which automatically require a specified annual increase (to the extent of this specified annual increase)).

Each Annual Business Plan will include (without prejudice to generality):

(a) a narrative description of the proposed objectives and goals for the Partnership and the Subsidiary Partnerships and Special Purpose Entities, which will include any proposed acquisition and any other major transactions to be undertaken by the Partnership or the Subsidiary Partnerships or Special Purpose Entities for this Fiscal Year (or other period),

(b) the status of the Projects and their markets,

(c) the identity and compensation of any employees and officers for the Partnership and the Subsidiary Partnerships and Special Purpose Entities,

(d) the Operating Budget described in Section x.5, and

(e) such other items as are requested by the General Partner (or its designee) or by any representative of the Management Committee or as are otherwise reasonably necessary to keep the General Partner and the Management Committee informed as to the business and affairs of the Partnership, the Subsidiary Partnerships and the Special Purpose Entities.

x.5. Operating Budget.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

On or before November 30 of each Fiscal Year of the Partnership, the Subsidiary Partnerships and the Special Purpose Entities, the General Manager will prepare and submit to the General Partner (or its designee) for its review and approval as part of the Annual Business Plan an annual combined operating budget ("Operating Budget") for the Partnership and each of the Subsidiary Partnerships and Special Purpose Entities for the ensuing Fiscal Year for the review and approval of the General Partner (or its designee).

The General Partner (or its designee) will use its reasonable commercial efforts to approve the Operating Budget no later than December 31 and to resolve any specific objections prior to this date.

In the event the General Partner (or its designee) fails to approve the Operating Budget prior to December 31 of any given Fiscal Year, the Operating Budget for the next Fiscal Year (until a new Operating Budget shall be adopted) shall be deemed to be equal to the prior Fiscal Year’s Operating Budget (increased for taxes and items provided for in any agreements which automatically require a specified annual increase (to the extent of this specified annual increase)).

Each Operating Budget will set forth on a detailed itemized basis –

(a) all receipts projected for the period of this Operating Budget and all expenses, by category, for the Partnership and each Subsidiary Partnership and each Special Purpose Entity (including, without prejudice to generality, all repairs and capital expenditures projected to be incurred during this period),

(b) the anticipated operating reserves projected to be required for this period,

(c) a five-year projection setting forth the estimated revenues, expenses and net operating income (or loss) expected to be incurred for the first five (5) years for the Partnership and each Subsidiary Partnership and each Special Purpose Entity and for each successive rolling five-year period (each current year and the immediately succeeding four years), which projection shall be updated to compare the actual results to the projected results set forth in the original Operating Budget, and

(d) information regarding the actual operating results of the Partnership and each Subsidiary Partnership and each Special Purpose Entity for the prior Fiscal Year.

The Operating Budget shall also include a detailed description of such other information, contracts, agreements and other matters reasonably necessary to inform the General Partner (or its designee) and the
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Management Committee of all matters relevant to the operation, management, maintenance and sale of any Project (or any portion thereof) or as may be reasonably requested by the General Partner (or its designee) or by any representative of the Management Committee.

The General Manager will not have any right or authority to incur costs or expenditures in excess of the line items set forth in the last approved Operating Budget without the prior consent of the General Partner (or its designee), other than as contemplated by Section x.2(b)(iii) of this Agreement or as permitted within any parameters agreed to in writing by the Management Committee in any this Operating Budget (for example, application of line item cost savings, contingency line item amounts, etc.); provided, however, that the General Manager shall have the authority to make emergency repairs to any of the Projects where the tenants’ safety is in jeopardy, so long as the General Manager provides notice to the General Partner (or its designee) and the Management Committee of this repairs no later than 24 hours after this repairs are made.

Notwithstanding the restrictions on the authority of the General Manager to expend funds set forth above in this Section x.5, in the event of an emergency, the General Manager shall have the authority to make expenditures up to $50,000 that are necessary in General Manager’s good faith judgement to protect the interests of the Partnership, the Subsidiary Partnerships and/or the Special Purpose Entities.

x.6. Removal of the General Manager.

(a) Right to Remove.

The General Partner (acting directly and outside the Management Committee) shall have the right to remove ***** as the General Manager of the Partnership at any time for any reason whatsoever (with or without Cause), by delivering ten (10) days’ prior written notice (“Removal Notice”) thereof to *****.

If ***** is removed as the General Manager of the Partnership pursuant to this Section x.6, regardless of whether any this removal is a result of Cause, then the General Partner (acting directly and outside the Management Committee) may (in its sole and absolute discretion) designate any person or entity as a replacement General Manager; provided, however, that neither the General Partner nor any Affiliate thereof shall be appointed as a replacement General Manager in the event that ***** is removed without Cause.

From and after the effective date of any removal of, or the resignation by, ***** as the General Manager,
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(i) the replacement General Manager (and not *****) shall be entitled to exercise all the rights, duties and obligations of the General Manager under this Agreement,

(ii) if the removal is a result of Cause, then the General Partner (acting directly and outside the Management Committee) shall have the right, but not the obligation, to exercise the Call Option set forth in Article VIII, and

(iii) if the removal is without Cause, then ***** shall have the right, but not the obligation, to exercise the Put Option set forth in Article **.

The General Partner (acting directly and outside the Management Committee) shall have the right, in its sole discretion, to remove any replacement General Manager and to appoint another replacement General Manager.

(b) Definition of Cause.

As used herein, the term “Cause” means the occurrence of any of the Call Events set forth in Sections 8.1(a) through (j) inclusive with respect to *****.

The General Partner expressly acknowledges and agrees that the failure of the General Manager to file any report required under this Agreement or otherwise by the Management Committee will not be deemed to be a material breach hereunder, unless this failure continues following the expiration of the applicable cure period under Section 8.1(b).

(c) Consequences.

(i) Contracts. If the Partners elect to remove ***** as General Manager, then the General Partner also may terminate any agreement between the Partnership or any Subsidiary Partnership or Special Purpose Entity and ***** or any Operating Entity (or other Affiliate) of ***** without penalty, except as provided in this Section x.6.

(A) Removal Without Cause.

If the General Partner elects to remove or replace ***** as the General Manager of the Partnership without Cause, and the General Partner elects to terminate a contract between the Partnership or a Subsidiary Partnership or Special Purpose Entity and ***** or an Operating Entity of *****; then the Partnership or the Subsidiary Partnership or Special Purpose Entity (as the case may be) shall be obligated to engage a third party other than an Affiliate of the General Partner to undertake the
services previously undertaken by the disengaged ***** or ***** Operating Entity, and the Partnership or the Subsidiary Partnership or Special Purpose Entity (as the case may be) shall not be required to pay any bonus or penalty to the disengaged ***** or Operating Entity on account of this terminated contract other than the amount of unpaid consideration payable to the disengaged ***** or Operating Entity accrued to date of termination for services performed to this date.

Notwithstanding anything to the contrary in this Agreement, the amount payable on account of the disengagement of ***** or any Affiliate of ***** under any Management Agreement shall be controlled by the terms of this Management Agreement.

(B) Removal With Cause.

If ***** is removed as the General Manager pursuant to this Section x.6 with Cause, then the Partnership or any Subsidiary Partnership or Special Purpose Entity (as the case may be) may engage either an Affiliate of the General Partner or a third party to complete the services under the terminated contract, and, notwithstanding the terms of any Management Agreement, the Partnership (or Subsidiary Partnership or Special Purpose Entity, as the case may be) shall not be required to pay any bonus or penalty to the disengaged ***** or Operating Entity on account of this terminated contract other than the amount of unpaid consideration payable to the disengaged ***** or Operating Entity accrued to date of termination for services performed to this date.

For purposes of this Section x.6(c)(i), amounts payable to ***** shall include any amounts that are accrued but unpaid under Sections x.12, x.13, x.14 and x.15 of this Agreement.

(ii) Interests.

If ***** is removed as the General Manager pursuant to this Section x.6 without Cause, then ***** shall retain its Class A Percentage Interest and the ***** Profits Interest.

If ***** is removed as the General Manager pursuant to this Section x.6 with Cause, then ***** shall retain its Class A Percentage Interest but shall, effective immediately upon this removal, forfeit the ***** Profits Interest and thereafter, except as otherwise expressly provided herein, will not be entitled to any allocations or distributions with regard to this forfeited ***** Profits Interest under Article V or Article VI of this Agreement.

x.7. Liability and Indemnity.
No General Partner, Affiliate of the Partnership, representative of the Management Committee, General Manager, Operating Entity or other authorized representative of the Partnership ("Indemnified Party") shall be liable or accountable in damages or otherwise to the Partnership or to the other Partners for any error of judgment or any mistake of fact or law or for anything that this Indemnified Party may do or refrain from doing hereafter, except in the case of fraud, willful misconduct, or gross negligence, or material breach of any of the terms of this Agreement in performing or failing to perform this Indemnified Party’s duties hereunder.

To the maximum extent permitted by law, the Partnership hereby indemnifies, defends, protects and agrees to hold each Indemnified Party wholly harmless from and against any and all loss, expense or damage (including, without prejudice to generality, attorneys’ fees and costs) suffered by this Indemnified Party by reason of anything which this Indemnified Party may do or refrain from doing hereafter for and on behalf of the Partnership and in furtherance of its interest; provided, however, (a) no Indemnified Party shall be indemnified, defended, protected or held harmless from any loss, cost, expense or damage which this Indemnified Party may suffer as a result of this Indemnified Party’s fraud, willful misconduct, gross negligence or material breach of any of the terms of this Agreement in performing or in failing to perform this Indemnified Party’s duties hereunder, and (b) any this indemnity shall be recoverable only from the assets of the Partnership.

The provisions of this Agreement (to the extent that they restrict the duties and liabilities of a General Partner (or an officer or representative thereof) otherwise existing at law or in equity) are agreed by the Partners to replace the statutory duties and liabilities of the General Partner (and this officer or representative).

x.8. Guarantees.

In no event shall the General Partner or any Affiliate thereof be required to guarantee any debt of the Partnership unless the General Partner or Affiliate agrees to do so.

x.9. Services to be Provided by the Key Individual.

***** agrees that as the General Manager it shall use its reasonable efforts to carry out the business and affairs of the Partnership in accordance with the policies and procedures established by the Management Committee and shall devote this time to the Partnership as is necessary, in the reasonable discretion of ***** for the efficient operation of the business and affairs of the Partnership.
In furtherance of the foregoing, ***** agrees that ***** (the “Key Individual”) is a key individual whose material participation in the operations of ***** is important to *****’s rendering services as the General Manager.

Except as otherwise provided in any applicable Annual Business Plan or Operating Budget, the Key Individual shall not be paid any compensation by the Partnership for providing this services.

Notwithstanding the foregoing, in no event shall the provisions of this Section x.9 be deemed to create an employment agreement between the Key Individual and the Partnership or any Subsidiary Partnership or Special Purpose Entity.

x.10. Broker’s Fee and Indemnity.

Each Partner represents and warrants that it has not dealt with any broker or agent in connection with this Agreement, and hereby agrees to indemnify, defend, protect and hold the other Partners and the Partnership, Subsidiary Partnerships or Special Purpose Entities wholly harmless from and against any and all liability, loss, costs, damage and expense (including, without prejudice to generality, attorneys’ fees and costs) which the other Partners or the Partnership, Subsidiary Partnerships or Special Purpose Entities may suffer or incur by reason of any claim by any broker or agent for any compensation with respect to this indemnifying Partner’s dealings in connection with this Agreement.

x.11. Contracts with Affiliates.

Except as otherwise expressly permitted under this Agreement, the following shall be prohibited: (a) the entry into any contract by the Partnership or any Subsidiary Partnership or Special Purpose Entity (as the case may be) with the General Partner or any Affiliate of the General Partner; (b) the payment by the Partnership or Subsidiary Partnership or Special Purpose Entity with respect to any this contract; the making of any amendment, modification, or rescission thereof; the declaration of a default thereunder; (c) the institution, settlement or compromise of a claim with respect thereto; the waiver of any rights of the Partnership or Subsidiary Partnership or Special Purpose Entity (as the case may be) against the other party(ies) thereto; or (d) the consent to the assignment of any rights and the delegation of any duties by the other party(ies) thereto.

The General Partner further acknowledges and agrees that, except as otherwise expressly permitted under this Agreement, any this contracts, payments, etc.
made with or to the General Partner or any Affiliate thereof shall in all events be commensurate with fees paid to independent third parties for providing similar services to projects similar in size, nature and location to the applicable Project.

x.1x. Asset Management.

The General Manager, Harding, and Paladin Realty Partners, L.L.C., a Delaware limited liability company (“Paladin Realty”), shall oversee the management of the assets of the Partnership.

An annual asset management fee equal to one-half of one percent (0.5%) of the purchase price of each Project shall be payable to *****; one-third of one percent (0.333%) to Paladin Realty, and one-sixth of one percent (0.167%) to Harding.

This fees shall be prorated and shall be payable in equal monthly installments, in arrears.

For purposes of the asset management fee, the “purchase price” of a Project shall be equal to (a) that set forth on Exhibit A hereto with respect to all Projects owned by the Partnership (or by a Subsidiary Partnership or Special Purpose Entity) as of the Effective Date or (b) if this Project is acquired by the Partnership after the Effective Date, the contract purchase price of this Project (which contract purchase price shall not be adjusted for closing costs, transaction costs, pro-rations, or any other adjustments unrelated to the value of the related real property) at the time the Project was acquired by the Partnership or Subsidiary Partnership or Special Purpose Entity.

x.13. Property Management Agreement.

The Partnership shall, and shall cause each Subsidiary Partnership and each Special Purpose Entity to, enter into a Property Management Agreement (each, a “Property Management Agreement”), in substantially the same form as Exhibit E attached hereto, with Trinity Property Consultants, LLC, a California limited liability company (“Trinity”), as property manager for each of the Projects; provided, however, that, notwithstanding the foregoing, if Trinity does not have sufficient resources in the relevant market with respect to any Project, the Partnership (or any Subsidiary Partnership or Special Purpose Entity, if applicable) may engage any other reputable third party with sufficient resources and expertise in this market, as determined by the General Partner in its sole discretion.
Each Property Management Agreement with Trinity shall provide for an annual property management fee equal to four percent (4%) of the gross revenues actually collected from the Projects.

For purposes of this Section x.13, “gross revenues” shall include all income from the operation of Projects (exclusive of sale, exchange or condemnation of the Projects and of one-time access payments or fees for the provisions of services by a third party vendor), determined on a cash basis, except for payments relating to refundable deposits, breakage or repairs, property taxes, payments by insurance companies on account of damage or casualty, but shall include payments made for lost rental income, and rental income for employee units.

This fee shall be prorated and shall be payable on a monthly basis on the last business day of each month for that month’s services, commencing on the date the respective Project is acquired.

x.14. Construction Management Agreement.

To the extent construction or renovation is contemplated as part of an acquisition and included in an Operating Budget reviewed and approved by the General Partner (or its designee), the Partnership will or may have entered into and will or may have caused each of the Subsidiary Partnerships and Special Purpose Entities to enter into a Construction Management Agreement (the “Construction Management Agreement”), in substantially the same form as Exhibit F attached hereto, with an Operating Entity of ***** as construction manager for the Projects.

The Construction Management Agreement shall provide for (a) a construction manager fee equal to ten percent (10%) of the hard construction costs as these costs are paid, (b) a general conditions fee equal to four percent (4%) of the hard construction costs as these costs are paid, and (c) a supervisory fee to be determined upon the mutual agreement of the General Partner (or its designee) and the construction manager; provided, however, that this hard construction costs shall not include construction management fees paid to *****.

This fees shall be payable in monthly installments, as construction costs are incurred.

To the extent the General Partner agrees to undertake a second generation renovation with respect to any Project, ***** shall be entitled to this fees with respect to this renovation as shall be mutually agreed upon by ***** and the General Partner (negotiating in good faith).

x.15. Due Diligence and Refinancing Fees.

(a) Due Diligence Fees.
The General Manager, Paladin Realty, and Harding shall be responsible for all due diligence to be performed on behalf of the Partnership prior to the acquisition by the Partnership of any Project.

If this Project is ultimately acquired by the Partnership then, for their services related to this due diligence, the General Manager shall be paid a fee of one percent (1.00%), Paladin Realty shall be paid a fee of one quarter of one percent (0.25%), and Harding shall be paid a fee of one-eighth of one percent (0.125%) of the contract purchase price of this Project (which contract purchase price shall not be adjusted for closing costs, transaction costs, pro-rata, or any other adjustments unrelated to the value of the related real property).

All these fees shall be paid by the entity that owns the related Project, and each entity shall be severally liable for any of these fees related to any Project owned by it.

(b) Refinancing Fees.

The General Manager, Paladin Realty, and Harding shall be responsible for negotiating and consummating all refinancings of all Projects; provided, however, the General Partner shall retain exclusive control of the tax aspects of all these sales and refinancings and of the decisions of whether to sell or refinance.

For their services related to the refinancing of any Project, the General Manager shall be paid a fee of three eighths of one percent (0.375%), Paladin Realty shall be paid a fee of three eighths of one percent (0.375%), and Harding shall be paid a fee of three sixteenths of one percent (0.1875%) of the total loan amount of this refinancing (which total loan amount shall not be adjusted for closing costs, lenders’ fees, or any similar costs or charges).

All these fees shall be paid by the entity that owns the related Project, and each entity shall be severally liable for any of these fees related to any Project owned by it.

x.16. Compensation and Reimbursements of General Partner.

Except as otherwise expressly provided in this Agreement or as provided in any applicable Operating Budget or in any other written agreement approved by the Management Committee, no General Partner or any constituent partner, member, shareholder, officer, director, employee, agent, or representative thereof or any Affiliate thereof, shall be entitled to receive any remuneration for services rendered to the Partnership or to be reimbursed for general administrative and overhead expenses.
x.17. Treatment of Fees and Reimbursements of the General Partner.

For financial and income tax reporting purposes, any and all fees paid by the Partnership to the General Partner or any Affiliate thereof shall be treated as expenses of the Partnership and, if paid to the General Partner, as guaranteed payments within the meaning of Section 707(c) of the Code.

To the extent any accrued portion of any this fee is not paid in full prior to the liquidation of the Partnership, this unpaid portion of this fee shall constitute a debt of the Partnership payable upon this liquidation.

x.18. Liability of the Limited Partners.

Notwithstanding anything to the contrary herein contained, none of the Limited Partners shall be liable for any debts, expenses, liabilities or obligations of the Partnership in excess of its Capital Account except as required in the Delaware Act.

To the extent required by law or the terms of this Agreement, any distributions to a Limited Partner (including, without prejudice to generality, any returned Capital Contributions) shall be restored to the Partnership as necessary to meet this Limited Partner’s share of any liability or loss of the Partnership which may have accrued prior to this distribution.

x.19. Extent of the General Partner’s Obligations and Rights.

(a) The General Partner shall devote a sufficient amount of its business time to the business of the Partnership to fulfill its obligations hereunder.

(b) The General Partner agrees that the assets of the Partnership will not be commingled with the assets of the General Partner or any other person and will be used or expended solely for the use of the Partnership.

(c) The General Partner shall have all the rights of a General Partner under the Delaware Act, provided, that the General Partner shall act exclusively through the Management Committee except as otherwise specifically set forth herein.

x.20. Interpretation of Indemnity Provisions.

The Partners acknowledge and agree that any indemnity obligation contained in this Agreement shall include, without prejudice to generality, the right of the indemnified party to recover attorneys’ fees and costs.
Personal Recourse Obligations.

In connection with (a) existing financing of any Projects prior to the date of this Agreement or (b) future financing of any Projects or replacement properties, the lender may have required or may require personal guarantees or indemnities with respect to certain obligations under the terms of the financing.

In the event that *****, in connection with financing that has been approved by the Partnership, becomes a guarantor or indemnitor of any obligations under this financing, the following shall apply: if a lender makes any demand or commences any action or proceeding to hold ***** personally liable under this guarantees or indemnities, the Partnership shall indemnify, defend and hold ***** harmless from and against any claims, losses, liability, damages, proceedings, costs and expenses, including reasonable attorneys’ fees, arising out of this guarantees or indemnities, except to the extent arising out of the fraud, gross negligence, willful misconduct or material breach of any of the terms of this Agreement by *****.

The foregoing indemnification shall survive any termination of this Agreement or the termination of ***** as General Manager.

Moreover, in the event ***** becomes this a guarantor or indemnitor and ***** is terminated as General Manager, the Partnership shall use its reasonable commercial efforts to obtain a release of ***** from this guarantees or indemnities and shall provide to the lender substitute guarantors or indemnitors in place of *****.

Many partnerships own their principal assets through one or more single member limited liability companies. The partnership agreements often describe in detail management authority of the partners, but fail adequately to describe who can cause the single member limited liability company to do what. For example, giving a partner power to approve or to disapprove sales of the partnership’s assets does not necessarily give the partner power to approve or to disapprove sales of assets owned by a single member limited liability company that is wholly owned by the partnership.

Clearly set forth any management fees and the proper tax characterization of those fees (for example, guaranteed payments). Clearly set forth restrictions on the manager’s rights to enter into transactions with affiliates and a mechanism for approving related-party transactions. Clarify the manager’s obligation to devote time to the partnership’s business.

Partnership agreements often provide clawback provisions under which management fees may be paid to a manager, subject to a clawback provision under which certain fees may have to be returned under certain conditions. Man-
agement fees, for example, may be clawed back by the partnership if the partnership fails to satisfy stated performance objectives. The tax treatment of clawback payments is outside of the scope of this Article. Consider the potential tax effects of a clawback provision in your partnership agreement.750

Do not be overly enamored, in defining managers’ powers, with the form agreement. Tailor powers that vest the managers with enough independent powers to manage the business on a day-to-day basis, but provide equity owners with reasonable controls. The managers should make regular reports to investors. The precise scope of powers of the managers is intrinsically deal specific. Define the extent to which managers are able to delegate performance of specific responsibilities to others and who will bear the cost.

Detail selection, term, and removal of managers. Clearly state the basis on which a manager can be removed.

Managers often are indemnified by the partnership on account of their activities as partnership managers. Clarify the fiduciary duties of the manager and the partners. Clarify what the managers are entitled to do and what they are not permitted to do on their own. Address dealing with manager affiliates, self-dealing transactions, conflicts of interest, and investment or business opportunities.

Consider permitting the partnership to elect officers. Having partnership officers often aids the partnership in the conduct of its daily operations. Officers’ duties (or, at least, a mechanism for determining their duties) should be detailed, in addition to the manner of reaching their compensation. Having partnership officers can be useful if the partnership is conducting an active trade or business.

Managers generally will expect indemnification from the partnership and advances for current expenses in indemnified litigation.751

Ensure that Major Decisions are consistent with the independent powers of a Liquidator in liquidation.752

---

750 See, for example, S. Schneider, How do Investment Fund Clawback Provisions Affect Partnership Income Allocations?, PASSTHROUGH ENTITIES 37 (July-August 2004).
751 See discussion of indemnification on page 248.
752 See text accompanying note 756.
93. Expenses.

Define what expenses should be treated as partnership expenses and borne by the partnership and which expenses are not. This is typical of an expenses provision for a partnership agreement:

Section x.x. Management Expenses.

(a) The Manager shall charge the Company for all reasonable out-of-pocket expenses incurred by the Manager or its Affiliates in connection with the Company’s business and the organization of the Company. This includes (without prejudice to generality) organizational expenses consisting of legal and accounting fees. The Manager may allocate to the Company (on any basis selected by the Manager in good faith that is consistent with good accounting practice) a portion of any and all expenses incurred by the Manager or its Affiliates for the mutual benefit of the Company and other Persons. This includes (without prejudice to generality) general, special and administrative expenses. The Company shall pay all expenses of the Company. These expenses include (without prejudice to generality):

(i) All salaries, compensation and fringe benefits of personnel employed by the Company and involved in the Company business. These include (without prejudice to generality) personnel who may also be employees of the Manager or its Affiliates (but exclude officers and directors of the Manager or its Affiliates).

(ii) All costs of borrowed money and all taxes applicable to the Company.

(iii) All legal, audit, accounting, consulting and brokerage fees.

(iv) All expenses and taxes incurred in the distribution, transfer and recording of documents evidencing ownership of an Interest in the Company.

(v) All expenses for the repair, remodeling, leasing, refinancing and operation of the Company’s property.

(b) The Company shall reimburse the Manager and its Affiliates for the actual cost of all goods and materials used for or by the Company. The Company shall pay or reimburse the Manager and its Affiliates for organizational expenses incurred to form the Company. This includes (without prejudice to generality) legal and accounting fees and brokerage fees. The Manager may allocate to the Company (on any basis selected by the Manager in good faith that is consistent with good accounting prac-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tice) a portion of any and all expenses incurred by the Manager or its Af-
filates for the mutual benefit of the Company and other Persons. This in-
cludes (without prejudice to generality) general, special and administra-
tive expenses. Notwithstanding the foregoing, the Manager shall pay (and
shall not be reimbursed by the Company for) these expenses:

(i) Salaries, compensation and fringe benefits of offic-
ers and directors of the Manager or its Affiliates.

(ii) Overhead expenses of the Manager or its Affiliates
(including (without prejudice to generality) rent and general office ex-
hores).

(iii) Costs of those services for which the Manager or its
Affiliates are entitled to compensation by way of the Management Fee.

94. Rights of Non-Managing Partners.

Clearly define management rights and voting power of non-managing
partners, plus any specific limitations on their participation in the business. Limit
the rights and power of non-managing partners if that is the partners’ intent. Con-
sider a covenant that non-managing partners will not interfere in the management
of the business of the partnership.

95. Transfer of Partnership Interests.

Transfer of partnership interests can be a contentious issue. All transfers
are sometimes prohibited. Transfers are sometimes permitted, but subject to rights
of first negotiation or rights of first refusal. These rights should be set forth un-
ambiguously and completely in your partnership agreement. No “school solution”
to the partnership transfer provision exists. A wide variety of possible provisions
address transfers of partnership interests. Partnership agreements often demon-
strate an infatuation with restricting transfers of partnership interests. Hesitate.
Determine whether the restrictions on transfer in your partnership agreement
make sense. Consider what you think should happen to a partnership interest if a
transfer is blocked by an antitransfer provision. What should happen to the par-
tnership interest of a deceased partner if your partnership agreement contains an
absolute restraint on transfer?753

753 Delaware Limited Liability Company Act Section 18-702 provides:
§ 18-702. Assignment of limited liability company interest.

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(a) A limited liability company interest is assignable in whole or in part except as provided in a limited liability company agreement. The assignee of a member’s limited liability company interest shall have no right to participate in the management of the business and affairs of a limited liability company except as provided in a limited liability company agreement and upon:

(1) The approval of all of the members of the limited liability company other than the member assigning the limited liability company interest; or

(2) Compliance with any procedure provided for in the limited liability company agreement.

(b) Unless otherwise provided in a limited liability company agreement:

(1) An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member;

(2) An assignment of a limited liability company interest entitles the assignee to share in such profits and losses, to receive such distribution or distributions, and to receive such allocation of income, gain, loss, deduction, or credit or similar item to which the assignor was entitled, to the extent assigned; and

(3) A member ceases to be a member and to have the power to exercise any rights or powers of a member upon assignment of all of the member’s limited liability company interest. Unless otherwise provided in a limited liability company agreement, the pledge of, or granting of a security interest, lien or other encumbrance in or against, any or all of the limited liability company interest of a member shall not cause the member to cease to be a member or to have the power to exercise any rights or powers of a member.

(c) Unless otherwise provided in a limited liability company agreement, a member’s interest in a limited liability company may be evidenced by a certificate of limited liability company interest issued by the limited liability company. A limited liability company agreement may provide for the assignment or transfer of any limited liability company interest represented by such a certificate and make other provisions with respect to such certificates.

(d) Unless otherwise provided in a limited liability company agreement and except to the extent assumed by agreement, until an assignee of a limited liability company interest becomes a member, the assignee shall have no liability as a member solely as a result of the assignment.

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Many different transfer provisions are used in partnership agreements. Consider:

- Why are you restricting transfers? What are transfer restrictions supposed to accomplish? Tailor restrictions to accomplish those objectives.
- What rights can the partner transfer?
- What contingencies or approval rights apply to the transfer?
- What transfers may be permitted free of restrictions (for example, certain transfers to trusts or controlled entities)?

(e) Unless otherwise provided in the limited liability company agreement, a limited liability company may acquire, by purchase, redemption or otherwise, any limited liability company interest or other interest of a member or manager in the limited liability company. Unless otherwise provided in the limited liability company agreement, any such interest so acquired by the limited liability company shall be deemed canceled.

Delaware Limited Liability Company Act Section 18-704 provides:

§ 18-704. Right of assignee to become member.

(a) An assignee of a limited liability company interest may become a member as provided in a limited liability company agreement and upon:

(1) The approval of all of the members of the limited liability company other than the member assigning limited liability company interest; or

(2) Compliance with any procedure provided for in the limited liability company agreement.

(b) An assignee who has become a member has, to the extent assigned, the rights and powers, and is subject to the restrictions and liabilities, of a member under a limited liability company agreement and this chapter. Notwithstanding the foregoing, unless otherwise provided in a limited liability company agreement, an assignee who becomes a member is liable for the obligations of the assignor to make contributions as provided in § 18-502 of this title, but shall not be liable for the obligations of the assignor under subchapter VI of this chapter. However, the assignee is not obligated for liabilities, including the obligations of the assignor to make contributions as provided in § 18-502 of this title, unknown to the assignee at the time the assignee became a member and which could not be ascertained from a limited liability company agreement.

(c) Whether or not an assignee of a limited liability company interest becomes a member, the assignor is not released from liability to a limited liability company under subchapters V and VI of this chapter.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- What happens to a partnership interest when the transfer has been blocked by an antitransfer restriction?
- Can the partner transfer all of the partner’s rights or merely economic rights?
- What transfer fees apply?
- What opinions of counsel should be required?
- Upon what conditions is the transferee substituted as a full partner?
- If the transferee is not substituted as a full partner, what are the transferee’s rights?
- Whether there is a continuing obligation for the transferor to be involved in the transferee (for example, a transferor continuing to be a general partner of the transferee if the transferee is a partnership) and what happens if this obligation is violated.
- Whether upstream transfers (transfers of interests in entities that are partners) are prohibited – and what happens if these transfers are undertaken despite a prohibition.
- Whether prohibited transfers are void or voidable.
- If a transfer of a partnership interest causes a property tax reassessment, should the transferee bear the continuing burden of the increased property taxes?
- If a transfer of a partnership interest causes the imposition of documentary transfer tax, should the transferee bear the continuing burden of the documentary transfer tax?
- Does the transfer provision unreasonably interfere with estate planning objectives?
- Does the transfer provision create unenforceable restrictions (such as transfer restrictions that interfere with the power of the trustee of a partner’s bankruptcy estate to realize value from his partnership interest after a bankruptcy of the partner)?

Common restrictions prohibit transfers that:

- May not be effected without registration under the federal securities laws or would otherwise violate the federal securities laws;
- Would result in the violation of any applicable state securities laws;
- Would result in the treatment of the partnership as an association taxable as a corporation or as a “publicly traded limited partnership” for tax purposes;
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Would cause the partnership to be required to register as an investment partnership, as such term is defined in the Investment Company Act of 1940, as amended; or
- Would substitute a minor as a partner.

Transfers of partnership interests can cause reassessment of property taxes under California’s Proposition 13 (real property reassessment) and can cause imposition of documentary transfer taxes on real property owned by the partnership when the transfer causes the partnership to terminate for federal income tax purposes. Transfer restrictions may prohibit transfers that cause reassessment or imposition of documentary transfer taxes. The partnership agreement may require the transferee partner to bear the increased taxes. Drafting these indemnification provisions is a nontrivial task.

Consider the possibility of a permitted transfer to a controlled entity followed by a transfer of an ownership interest in that entity. This technique often can be used to defeat poorly-drafted anti-transfer provisions. (The issue of upstream transfers should be addressed regardless of whether in the context of transfer to a controlled entity.) Some transfer provisions will prohibit transfers of an equity interest in a partner, for example, if the transfer results in change of control of the partner. Some transfer provisions will permit the partnership to retire the interest of a partner at a formula price upon a change of control of the partner. Drafting to restrict upstream transfers of interests in partners and entities controlling partners requires care.

Many partners are particularly keen to permit transfers of partnership interests if the transfers are undertaken for estate planning purposes. Other partners should consider how keen they may be to have a divorced spouse or a child as a substituted partner. Consider state marital property law in drafting antitransfer provisions.754

Address what happens on the death, liquidation, or merger of a partner. A partnership conceivably might seek to block the merger or liquidation of a partner under the antitransfer provision in a partnership agreement. Whether this would succeed or fail is a matter local courts will decide. The partnership cannot block the death of a partner with an antitransfer provision.

Address both voluntary and involuntary transfers of partnership interests. You may want different remedies for voluntary transfers and involuntary transfers.

754 Estate planning issues and marital property issues are outside of the scope of this article. These issues nevertheless can be important in drafting partnership agreements.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Be careful in your definition of “transfer” to be sufficiently expansive so that your transfer provision addresses the full range of transactions that you intend to address.

Some transfer provisions prohibit the transfer of the complete partnership interest (viz. the right to become a substituted partner and to possess such voting and management rights as the transferring partner possessed prior to the transfer). These provisions typically permit the transfer of an interest in profits and distributions. The transferee acquires a right to distributions, but is not substituted as a partner. The parties need to consider whether the transferee will have sufficient rights to protect his position as a transferee. As a general matter, the rights of a transferee of a profits interest are limited. Consider enumerating the rights of the transferee of a partnership interest when the transferee is not admitted as a substituted partner. The transferee apparently is not entitled to normally fiduciary duties from the managers. The transferee perhaps should be entitled to have the managers exercise good faith in their relations with the transferee. A party negotiating for a potential transferor may seek objective criteria permitting transfer of a partnership interest and substitution of the transferee as a partner in order to avoid the inconvenience of the transferee being limited to a mere assignee who is not admitted as a substituted partner. The partnership agreement should clearly specify when the transferee is admitted as a substituted partner and should detail the rights of a transferee who is not admitted as a substituted partner.

Partnership agreements frequently limit (or purport to limit) transfers of partnership interests by a bankruptcy court. Bankruptcy courts may determine that your partnership agreement and the partnership interest are subject to the power of the trustee to accept, to reject, or to assign an executory contract. Whether limitations in your partnership agreement on the authority of the trustee in bankruptcy or the bankruptcy court will be respected in bankruptcy is a matter of controversy. The bankruptcy court whose powers you seek to limit may be the arbiter of this controversy. One can guess who is likely to win – the partnership which seeks to restrict the transfer or the bankruptcy court which seeks to preserve the value of the bankruptcy estate.

Partnership agreements often contain buy-sell agreements, rights of first offer, rights of first negotiation, rights of first refusal, tag-along rights, drag-along rights, puts, calls, black-out periods, preemptive rights, etc. There is practically no type of transfer agreement that does not find its way into one partnership agreement or another. There is no single provision that is best for all partnership agreements. Transfer rights must be tailored on a case-by-case basis. Purchase rights should be fully detailed and should address practically all of the considerations in a purchase and sale agreement for an interest in a partnership (including (without prejudice to generality) the treatment of distributions between exercise of
purchase rights and date of closing). The many considerations in these various provisions are beyond the scope of this Article.

Ensure that the rights relating to a transfer of a partnership interest not so greatly oppress the transferring partner that a court will not enforce the rights.

Partnership agreements often contain provisions that permit the partnership to buy-out the estate of a deceased partner or perhaps another transferring partner at “book” value of the transferred partnership interest. Such a provision can have an oppressive effect on the estate when there is a substantial disparity between “book” value and fair market value. This can create a cloud, in appropriate circumstances, over whether a court will enforce the provision. Advisors should not automatically assume that provisions providing for a buy-out at “book” value are automatically unenforceable. These provisions are common, and may well be generally enforceable. These provisions create a special problem when the partner whose interest is being bought out has a negative capital account and the partnership agreement requires buy-out at negative capital account. Applied literally, such a provision would seem to require that the partner whose interest is being bought out should pay the partnership rather than the partnership pay the partner. What a court would do with such a provision is a matter of conjecture.

Consider whether your antitransfer provisions unnecessarily interfere with estate planning, family relationships, and bankruptcy proceedings.

This is a typical provision (not especially robust in controlling up-stream transfers) governing transfers of partnership interests:

Section x.1 Limited Partners’ Rights to Transfer.

(a) No Limited Partner may Transfer all or any portion of its Partnership Interest to any Transferee prior to the end of the Restriction Period without the Consent of the General Partner (which Consent may be withheld in its sole and absolute discretion). Notwithstanding the foregoing, any Limited Partner may undertake a Permitted Transfer (at any time, without the Consent of the General Partner).

(b) Each Limited Partner and each Transferee of a Partnership Interest or Assignee pursuant to a Permitted Transfer, has the right to Transfer all or any portion of its Partnership Interest to any Person after the Restriction Period (subject to Section x.3 of this Agreement and the satisfaction of each of these conditions):

(i) Any Transfer of a Partnership Interest may be made only to a Qualified Transferee.

(ii) In connection with any proposed Transfer of a Partnership Interest, the General Partner has the right to require an opinion of counsel (reasonably satisfactory to the General Partner) to the ef-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

fact that the proposed Transfer (A) may be effected without registration under the Securities Act and (B) will not otherwise violate any federal or state securities laws or regulations applicable to the Partnership or the Partnership Interest Transferred. If (in the opinion of this counsel) this Transfer would require the filing of a registration statement under the Securities Act or otherwise would violate any federal or state securities laws or regulations applicable to the Partnership or the Partnership Interest, the General Partner may prohibit any Transfer otherwise permitted under this Section x.1 by a Limited Partner of a Partnership Interest.

(c) The conditions of Sections x.1(b) of this Agreement do not apply in the case of a Permitted Transfer.

(d) Any Transfer otherwise permitted under this Agreement (whether or not this Transfer is effected during or after the Restriction Period) is conditioned on the Transferee assuming all of the obligations of the Transferor Limited Partner under this Agreement with respect to this Transferred Partnership Interest.

(e) No Transfer shall relieve the Transferor Partner of its obligations under this Agreement without the approval of the General Partner. The immediately previous sentence does not apply to a transfer pursuant to a statutory merger or consolidation wherein all obligations and liabilities of the Transferor Partner are assumed by a successor by operation of law.

(f) Any Transferee (whether or not admitted as a Substituted Limited Partner) shall take and hold the Transferred Partnership Interest subject to the obligations of the Transferor under this Agreement.

(g) No Transferee (whether by a voluntary Transfer, by operation of law or otherwise) has any rights under this Agreement (other than the rights of an Assignee as described in Section x.3 of this Agreement) unless the Transferee is admitted as a Substituted Limited Partner.

(h) If a Limited Partner is subject to Incapacity, the executor, administrator, trustee, committee, guardian, conservator or receiver of the Limited Partner’s estate has all of the rights of a Limited Partner (but no greater rights than those enjoyed by other Limited Partners) for the purpose of settling or managing the estate, and such power as the Incapacitated Limited Partner possessed to Transfer all or any part of its Partnership Interest. The Incapacity of a Limited Partner shall not dissolve or terminate the Partnership.

(i) No Transfer by a Limited Partner of its Partnership Interest (including (without prejudice to generality) any Redemption, any Per-
mitted Transfer, any other acquisition of Partnership Interest by the Partnership or the General Partner) may be made to or by any person if—

(i) In the opinion of legal counsel for the Partnership, the Transfer would result in the Partnership being treated as an association taxable as a corporation, or

(ii) This Transfer would be effectuated through an “established securities market” or a “secondary market (or the substantial equivalent thereof)” within the meaning of Code Section 7704.

(j) For purposes of this Section x.1,

(i) “Family Member” means, as to a Person that is an individual, the Person’s spouse, ancestors, descendants (whether by blood or by adoption), brothers and sisters and intestate trusts of which only the Person and his spouse, ancestors, descendants (whether by blood or by adoption), brothers and sisters (whether by blood or by adoption, by whole or half blood) are beneficiaries. “Family Member” also includes any former spouse of the Limited Partner, any descendant of a former spouse of the Limited Partner, the estate of the Limited Partner and any Charity. The domestic partner of a Limited Partner or a member with a Limited Partner of a legal union of two persons of the same sex, other than a marriage, that was validly formed under state law, and that is substantially equivalent to a “domestic partnership” (as determined under California Family Code Section 297 or comparable provisions of the laws of other jurisdictions), regardless of whether it bears the name “domestic partnership,” shall be treated for this purposes as a spouse of this Person.

(ii) “Permitted Transfer” means, with respect to any Limited Partner—

(A) The Transfer of all or part of its Partnership Interest to any Family Member.

(B) The Transfer of all or part of its Partnership Interest to the Limited Partner’s estate or a beneficiary of its estate.

(C) The Transfer of all or part of its Partnership Interest to any partner of the Limited Partner if the Limited Partner is a partnership or limited partnership. The immediately previous sentence is qualified by the requirement that the Transferee is (in any such case) a Qualified Transferee.

(D) The Transfer of all or part of its Partnership Interest to any member of the Limited Partner if the Limited Partner is a limited liability company. The immediately previous sentence is qualified
by the requirement that provided that the Transferee is, in any such case, a Qualified Transferee.

(E) The pledge (a “Pledge”) of all or any portion of its Partnership Interest to a lending institution as collateral or security for a bona fide loan or other extension of credit, and Transfer of the Pledged Partnership Interest to the lending institution in connection with the exercise of remedies under the loan or extension or credit (including a foreclosure).

(F) The Transfer of all or a part of its Partnership Interest to its estate in bankruptcy or by its estate in bankruptcy, under the order of a bankruptcy court.

(G) Any Transfer by operation of law.

(H) The Transfer of all or part of its Partnership Interest with the Consent of the General Partner.

(iii) “Qualified Transferee” means an “accredited investor” as defined in Rule 501 under the Securities Act.

Section x.2 Substituted Limited Partners.

(a) No Limited Partner has the right to substitute a Transferee as a Limited Partner in its place. This includes (without prejudice to generality) Transferees pursuant to Transfers permitted by Section x.1 of this Agreement.

(b) A Transferee of the Partnership Interest of a Limited Partner may be admitted as a Substituted Limited Partner only with the Consent of the General Partner. This Consent may be given or withheld by the General Partner in its sole and absolute discretion.

(c) The failure or refusal by the General Partner to permit a Transferee of any Partnership Interest to become a Substituted Limited Partner shall not give rise to any cause of action against the Partnership or the General Partner.

(d) Subject to the foregoing, a Transferee shall not be admitted as a Substituted Limited Partner until and unless it furnishes to the General Partner—

(i) Evidence of acceptance of all of the terms, conditions and applicable obligations of this Agreement. This evidence shall be in form and substance satisfactory to the General Partner (in its sole and absolute discretion).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(ii) A counterpart signature page to this Agreement executed by the Assignee.

(iii) Such other documents and instruments as may be required or advisable (in the sole and absolute discretion of the General Partner) to effect the Assignee’s admission as a Substituted Limited Partner.

(e) A Transferee who has been admitted as a Substituted Limited Partner in accordance with this Article X has all of the rights and powers and shall be subject to all of the restrictions and liabilities of a Limited Partner under this Agreement.

(f) Upon the admission of a Substituted Limited Partner, the General Partner shall amend Schedule A to reflect the name and Percentage Interest of the Substituted Limited Partner and to eliminate or to adjust (if necessary) the name and Percentage Interest of the predecessor of the Substituted Limited Partner.

Section x.3 Assignees. If the General Partner (in its sole and absolute discretion) does not Consent to the admission of any permitted Transferee as a Substituted Limited Partner (as described in Section x.2 of this Agreement), the Transferee shall be considered an “Assignee” for purposes of this Agreement. An Assignee shall be treated as having had assigned to it (and shall receive) only distributions from the Partnership and the share of Net Income, Net Losses, and any other items of gain, loss, deduction and credit of the Partnership attributable to the Partnership Interest assigned to the Transferee. Except as otherwise required by Section y.y of this Agreement, the Assignee shall not be treated as a holder of the Partnership Interest for any other purpose under this Agreement. The Assignee shall not be entitled to vote the Partnership Interest in any matter presented to the Limited Partners for a vote. The transferred Partnership Interest shall be treated as voting on the matter in the same proportion as all other Partnership Interests held by Limited Partners are voted. When any the Transferee desires to make a further assignment of any the Partnership Interest, the Transferee shall be subject to this Article X to the same extent and in the same manner as any Limited Partner desiring to make an assignment of Partnership Interest.

This is another typical antitransfer provision:

Section x.1. Restrictions on Transfer.

(a) Except as expressly permitted by this Agreement, no Member may Transfer all or any part of its Membership Interest in the Company or to permit any Transfer of ownership interest in the Member or in the partners, members or shareholders of the Member except for a Transfer:
(i) To the Company, another Member, or a partner, member, shareholder or Affiliate of a Member;

(ii) If the proposed Transferor is a natural Person, to a Family Member of the Transferor or a trust established for the benefit of the Family Member or by succession or testamentary disposition upon his death;

(iii) If the proposed Transferor is a trust, to a Family Member of the Transferor; or

(iv) Any other Transfer approved by the Managers.

Any attempted or actual Transfer shall be null and void ab initio and of no force and effect, unless made in compliance with this Article X.

(b) Any Transfer of any interest in the Company under this Article X is subject to these conditions:

(i) The Transferee shall assume in writing each of the obligations of the Transferor to the Company;

(ii) The Transferee shall agree in writing to be bound by each of the terms and conditions of this Agreement;

(iii) The Transferee shall deliver to the Company instruments of assumption and security reasonably approved by the Managers for the payment and performance of all obligations of or attendant to the Membership Interest so Transferred and assumed; and

(iv) The requirements of Sections x.4 and x.5 shall be satisfied.

Section x.2. No Take-Along Rights. There shall be no right of any other Member to participate in any Transfer by a Member permitted under this Agreement.

Section x.3 Bankruptcy or Dissolution of Members. Upon the occurrence of a Bankruptcy or the dissolution of any Member,

(a) The Member shall cease to have any approval rights under this Agreement; and

(b) The trustee in Bankruptcy, receiver or other legal representative of the Bankrupt Member or other legal representative of the dissolved Member shall succeed to all of the rights of an assignee of the Member and shall have the same right (subject to the same limitations) as the Bankrupt or dissolved Member would have had under Section x.1 to assign its interest in the Company (subject to the substitution rules of Section x.4 and the buy-out provisions of Article Y).
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

Section x.4 Substitution of Member. Subject to the restrictions and approval rights of the Members set forth in Section x.1 and Section x.5, the Transferee of any Transfer by a Member (an “Assignee”) shall become a substitute Member only if these requirements are met:

(a) The assignor Member so provides in an instrument of assignment.

(b) The Assignee agrees in writing to be bound by this Agreement, the Certificate and any amendments to this Agreement.

(c) The Managers (including the Transferor) approve the substitution.

The Assignee shall become a substitute Member if these requirements have been met (in addition to those stated above):

(d) The assignor Member provides that the Assignee shall become a substitute Member and the Assignee agrees to be bound as stated above.

(e) The Managers approve admission of the Assignee substitution is and approval by the Managers is obtained.

(f) The Assignee shall have paid to the Company all costs and expenses of reviewing the instrument of assignment (if appropriate).

(f) An amendment to the Certificate is executed to reflect the substitution (if required by law).

No Person shall be considered a Member unless named in this Agreement, or unless admitted to the Company as provided in this Agreement. The Company, each Member and any other Persons having business with the Company need deal only with Members so named or so admitted. They shall not be required to deal with any other Person by reason of an assignment or pledge by a Member (or realization of a pledge) or by reason of the death of a Member. In the absence of approval by the Managers of the substitution of a Member for a deceased Member as required by this Section x.4, any payment to the executors, administrators or personal representatives of the deceased Member shall acquit the Company of all liability with respect to the payment to any other Persons who may be interested in the payment by reason of the death of the Member. An Assignee of an interest in the Company who is not admitted as a substitute Member as required by this Section x.4 shall receive the economic benefits of the interest purported to be Transferred but shall not be considered a Member for any purposes and has none of the rights of a Member under this Agreement or under the Act.
Section x.5  Additional Transfer Restrictions.

(a)  Notwithstanding any provision of this Agreement to the contrary (and subject to the limitations in Sections x.1 through x.4), a Member’s ability to Transfer all or any portion of its Membership Interest, or to permit the Transfer of direct or indirect (through one or more intermediaries) ownership interest in the Member relating specifically or generally to the Member’s interest in the Company, shall be subject to these additional restrictions:

(i)  No Transfer of all or any portion of the interest shall be effective unless (A) the Transfer complies with the Transfer restrictions in all agreements to which the Company or the Member is a party, (B) the interest is registered under the Securities Act and any applicable state securities laws, or an exemption from registration is available, and (C) for any direct Transfer of an interest in the Company, the Company has received an opinion of counsel (reasonably approved by the Managers) to such effect (unless the requirement that the Company receive such legal opinion is waived by the Managers).

(ii)  No Member may Transfer any portion of its interest in the Company or take any other action that would cause the Company to be –

(A)  Treated as a “publicly traded partnership” (within the meaning of Code Section 7704); or

(B)  Classified as a corporation (or as an association taxable as a corporation) (within the meaning of Code Section 7701(a)).

(iii)  No Member may Transfer all or any portion of its Company interest or to take any other action that would result in a termination of the Company as a partnership within the meaning of Code Section 708(b)(1)(B) (“Tax Termination”), unless approved by the Managers. “Action” includes (in the case of any Member that is a corporation, limited liability company or partnership or a partner or member of a partnership or limited liability company that is a Member) a Transfer of any interest in the entity.

(iv)  Unless arrangements concerning withholding are reasonably approved by the Managers (if this withholding is required of the Company), no Member may Transfer all or any portion of its Membership Interest in the Company to any Person, unless this Person is a United States Person (as defined in Code Section 7701(a)(30)) and is not subject to withholding of any federal tax.
(v) No Member may Transfer all or any portion of its Membership Interest if the Transfer would (i) cause the assets of the Company to be treated as “plan assets” under Employee Income Security Act of 1974 or its accompanying Treasury Regulations or the Code or (ii) result in any “prohibited transaction” under Employee Income Security Act of 1974 or its accompanying Treasury Regulations affecting the Company.

(b) Any purported Transfer or any other action taken in violation of this Article X shall be void ab initio.

Section x.6 Transfer Indemnification and Contribution Provisions. Each Member shall indemnify, defend and hold the Company and each other Member and the Managing Member and the shareholders, partners, employees, agents, members and Affiliates of each of them harmless from any Liabilities in any way arising from the failure of a Transfer of any Membership Interest in the Company to comply with all applicable federal and state securities laws, or the impact of the Transfer upon compliance of the Company and its Members with those securities laws in connection with any previous Transfer of a Membership Interest. The immediately previous sentence includes (including (without prejudice to generality) all registration or qualification requirements and anti-fraud requirements of securities laws. If the preceding indemnity is unenforceable to any extent, then (to such extent) the Member otherwise required so to indemnify the Company and the other Members and the Managing Member shall contribute to any loss, liability, cost or expense resulting from the actions, omissions or events set forth in the above indemnification to the extent of its responsibility therefor (as determined by the trier of fact).

Section x.7 Basis for Restrictions and Remedies. The Members acknowledge that the relationship of each Member to the other Members is a personal relationship and that the restrictions on the power of each Member to withdraw or Transfer its interest in the Company and to permit the Transfer of ownership interest in the Member and the remedies of Article Y (including (without prejudice to generality) the purchase and redemption rights contained therein) (i) are necessary to preserve such personal relationship and to safeguard the investment of the other Members in the Company and the Company’s investment in the Property, (ii) were a material inducement to the other Members entering into this Agreement and (iii) shall be enforceable notwithstanding the Bankruptcy of any Member or any applicable prohibition against restraints on alienation.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Many Transfer restrictions are accompanied with buy-out provisions (such as rights of first negotiation or rights of first refusal).

96. Liquidation and Dissolution.

Section x.x. Dissolution. The Company shall be dissolved, its assets shall be disposed of and its affairs shall be wound up upon the first to occur of these events:

(a) A determination of all of the Members to dissolve the Company.

(b) The sale of all or substantially all of the assets of the Company.

(c) The entry of a judicial decree of dissolution of the Company under the Act.

Section y.y. Winding Up. Upon the occurrence of any event specified in Section x.x, the Company shall continue solely for the purpose of winding up its affairs in an orderly manner, liquidating its assets, satisfying the claims of its creditors, and distributing any remaining assets in cash or in kind, to the Members. The Manager shall be responsible for overseeing the winding up and Liquidation of the Company. The Manager –

(a) Shall cause the Company to sell or otherwise to liquidate all of the Company’s assets (except to the extent that the Manager determines to distribute any assets to the Members in kind, discharge or make reasonable provision for all of the liabilities of the Company and all costs relating to the dissolution, winding up, and liquidation and distribution of assets),

(b) Shall establish such reserves as may be reasonably necessary to provide for contingent liabilities of the Company (for purposes of determining the Capital Accounts for distribution to the Members, the amounts of the reserves shall be treated as an expense of the Company), and

(c) Shall distribute the remaining assets to the Members (in the manner specified in Section z.z).
This provision addresses the winding up and Liquidation of the partnership:

Section x.3. Dissolution of Partnership.

(a) The Partnership shall be dissolved, wound up and terminated upon the first to occur of these events (each an “Event of Termination”):

(i) The Dissolution Date;

(ii) The sale of all of the Properties of the Partnership;

(iii) The dissolution, termination, bankruptcy or required withdrawal of the General Partner, or the occurrence of any other event with respect to the General Partner that would make it unlawful for the business of the Partnership to be continued;

(iv) The General Partner and a Majority-in-Interest of the Limited Partners elect to dissolve the Partnership; or

(v) The occurrence of any event that would make it unlawful for the business of the Partnership to be continued.

(b) A Majority-in-Interest of the Limited Partners may elect to continue the Partnership upon the occurrence of an event described under Section x.3(a)(iii). In this event, a Majority-in-Interest of the Limited Partners shall elect a successor General Partner. The successor General Partner shall assume all of the rights and obligations of the replaced General Partner under this Agreement from and after election (including (without prejudice to generality) the replaced General Partner’s funded Capital Commitments). After replacement of the General Partner, the replaced General Partner shall be treated as a Limited Partner for all purposes of this Agreement. The replaced General Partner shall cease to be liable as General Partner on the account of the activities of the Partnership subsequent to replacement.

(c) If the Partnership dissolves for any reason, the General Partner (or, if the General Partner has been dissolved, withdrawn or removed, then a Liquidating agent appointed by a Majority-in-Interest of the Limited Partners (the General Partner or the person so designated is referred to as the “Liquidator”)) shall commence to wind up the affairs of the Partnership and to liquidate the Partnership’s assets. The Partners shall continue to share all income, losses and distributions during the period of Liquidation in accordance with Article X. The Liquidator has full right and unlimited discretion to determine the time, manner and terms of any sale or sales of Partnership property pursuant to the Liquidation (give-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ing due regard to the activity and condition of the relevant market and general financial and economic conditions).

(d) The Liquidator has all of the rights and powers with respect to the assets and liabilities of the Partnership in connection with the Liquidation and termination of the Partnership that the General Partner would have with respect to the assets and liabilities of the Partnership during the term of the Partnership [Note: should the Liquidator be subject to the approval provisions for Major Decisions?]. The Liquidator is authorized and empowered to execute any and all documents necessary or desirable to effectuate the Liquidation and termination of the Partnership and the transfer of any assets. [Note: consider modifying Major Decisions so that Major Decisions are overridden (or partially overridden) by this provision. Powers of the Liquidator should be consistent with the provision concerning Major Decisions.]

Section x.4. Distribution in Liquidation. The Liquidator (as soon as practicable) shall wind up the affairs of the Partnership and shall sell and/or distribute the assets of the Partnership. The Liquidator shall not distribute assets of the Partnership other than cash, cash equivalents or Marketable Securities without prior written consent of the Partners who are to receive the distributions. The assets of the Partnership shall be applied in this order of priority:

(a) First, to pay the costs and expenses of the winding up, Liquidation and termination of the Partnership.

(b) Second, to creditors of the Partnership, in the order of priority provided by applicable law. This includes (without prejudice to generality) fees payable to the General Partner (including (without prejudice to generality) any accrued and unpaid Management Fee) or its Affiliates. This does not include those liabilities to the Limited Partners or to the General Partner in their capacity as Partners.

(c) Third, to establish reserves reasonably adequate to meet any and all contingent or unforeseen liabilities or obligations of the Partnership. The immediately previous sentence is qualified by the requirement that (at the expiration of the period of time as the Liquidator deems advisable) the balance of the reserves remaining after the payment of such contingencies or liabilities shall be distributed as provided in this Section x.4.

(d) Fourth, to the Partners in repayment of loans (if any) made by them to the Partnership and to the General Partner for any expenses of the Partnership paid by them (to the extent that they are entitled to reimbursement).
Fifth, to the Partners in accordance with Section x.x [or, to Partners with positive balances in their Capital Accounts, in accordance with the ratio of those positive balances].

If the Liquidator (in its sole and absolute discretion) determines that assets other than cash are to be distributed, then the Liquidator shall cause the fair market value of the assets not so liquidated to be determined. The assets shall be retained or distributed by the Liquidator in accordance with these rules:

(i) The Liquidator shall retain assets having a value (net of any liability related to these assets) equal to the amount by which the net proceeds of liquidated assets are insufficient to satisfy the requirements of subparagraphs (a), (b), and (c), of this Section x.4; and

(ii) The remaining assets shall be distributed to the Partners (subject to Section y.y) in the manner specified in subparagraphs (d) and (e) of this Section x.4.

If the Liquidator (in its sole and absolute discretion) deems it not feasible or desirable to distribute to each Partner its allocable share of each asset, the Liquidator may allocate and distribute specific assets to one or more Partners (individually or as tenants-in-common) as the Liquidator shall reasonably determine to be fair and equitable. For this purpose, the Liquidator shall take into consideration, inter alia, the fair market value of the assets, the liens (if any) to which the property may be subject, and the tax consequences of the proposed distribution upon each of the Partners (including both distributees and others, if any). Any distributions in kind shall be subject to the conditions relating to the disposition and management thereof as the Liquidator (in his sole and absolute discretion) deems reasonable and equitable.

Section x.5. Final Reports. Within a reasonable time following the completion of the Liquidation of the Partnership’s properties, the Liquidator shall supply to each of the Partners a statement audited by the Partnership’s accountants in accordance with generally accepted auditing standards that shall set forth the assets and liabilities of the Partnership as of the date of complete Liquidation and each Partner’s portion of distributions under Section x.4.

Section x.6. Rights of Limited Partners. Except as set forth in Section y.y, each Limited Partner shall look solely to the assets of the Partnership for all distributions with respect to the Partnership and the Partner’s Capital Contribution (including return thereof), and the Partner’s share of profits or losses thereof, and has no recourse therefor (upon dissolution or otherwise) against the General Partner or any other Limited
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Partner. No Partner has any right to demand or to receive property other than cash upon dissolution and termination of the Partnership.

Section x.7. Deficit Restoration.

(a) Notwithstanding any other provision of this Agreement to the contrary, upon Liquidation of a Limited Partner’s Interest (whether or not in connection with a Liquidation of the Limited Partnership), no Limited Partner has any liability to restore any deficit in its Capital Account.

(b) No allocation to any Limited Partner of any loss (whether attributable to depreciation or otherwise) shall create any asset of or obligation to the Limited Partnership (even if the allocation reduces a Limited Partner’s Capital Account or creates or increases a deficit in the Limited Partner’s Capital Account).

(c) No Limited Partner shall be obligated to pay any such amount to or for the account of the Limited Partnership or any creditor of the Limited Partnership.

(d) The General Partner is obligated to restore any deficit in its Capital Account (as determined after including all Capital Account adjustments for the Partnership taxable year during which the Liquidation occurs).\(^{755}\) The General Partner is unconditionally obligated to restore the amount of the deficit balance to the Partnership by the end of the taxable year of the Liquidation (or, if later, within 90 days after the date of the Liquidation). This amount (upon Liquidation of the Partnership) shall be paid to creditors of the Partnership or distributed to other Partners in accordance with their positive Capital Account balances. For this purpose, the Liquidation of a Partner’s interest in the Partnership occurs upon the earlier of (1) the date upon which there is a Liquidation of the Partnership, or (2) the date upon which there is a Liquidation of the Partner’s interest in the Partnership under paragraph (d) of Treasury Regulations Section 1.761-1. The Liquidation of a Partnership occurs upon the earlier of (1) the date upon which the Partnership is terminated under Section 708(b)(1), or (2) the date upon which the Partnership ceases to be a going concern (even though it may continue in existence for the purpose of

\(^{755}\) It is uncertain under most limited partnership statutes whether the general partner has a deficit restoration obligation automatically in the absence of a provision in the partnership agreement. Even if partnership law expressly provides for the general partner to have a deficit restoration obligation, it is doubtful that this provision would satisfy the Treasury Regulations requirements for a deficit restoration obligation.
winding up its affairs, paying its debts, and distributing any remaining balance to its Partners).

Section x.8. Termination. The Partnership shall terminate when all property owned by the Partnership has been disposed of and the assets have been distributed as required by Section x.4.

Section x.9. Certificate of Cancellation. The Liquidator shall then execute and cause to be filed a Certificate of Cancellation of the Partnership with the Delaware Secretary of State.

This is a Liquidation provision from another partnership agreement:

Section x.x. Liquidation and Dissolution.

(a) Events of Dissolution. The Company shall be dissolved upon the occurrence of any of these events:

(i) Any sale of the Company’s interest in the Property (unless the Company provides purchase money financing in connection with the sale, in which case the Company shall be dissolved upon the repayment in full of the financing);

(ii) The written agreement of all of the Members; or

(iii) As may otherwise be required under the Act.

(b) Procedure for Winding Up and Distribution. If the Company is dissolved, the Managing Member shall wind up its affairs. On winding up of the Company, the assets of the Company shall be distributed in accordance with Section x.x(d).

(c) Filing of Certificate of Dissolution. If the Company is dissolved, the Managing Member shall promptly file a Certificate of Dissolution with the Wyoming Secretary of State. If there are remaining Members, the Certificate shall be filed by the last Person to be a Member; if there are no remaining Members, nor any remaining Person who last was a Member, the Certificate shall be filed by the legal or personal representatives of the Person who last was a Member.

(d) The Managing Member shall settle the liabilities of the Company with payments in the following order in settling accounts of the Company upon dissolution:

(i) To creditors other than Members (in the order of priority provided by law);

(ii) To creditors who are Members in order of priority (except amounts owed to Members on account of their Capital Contributions);
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(iii) To the Members (in the amounts and in the priority set forth in Section y.y).

(e) Limitation Upon Liability. Each Member shall look solely to the assets of the Company for the return of its positive Capital Account balance (if any), except as otherwise specifically set forth in this Agreement.

(f) Compliance With Regulations. All payments to the Members upon the winding-up and dissolution of the Company shall be made strictly in accordance with the positive Capital Account balance limitation and other requirements of Treasury Regulations Section 1.704-1(b)(2)(ii)(d).

(g) Negative Capital Accounts. No Member shall be obligated to restore a negative Capital Account.

Provisions concerning liquidation should clearly specify events of liquidation and should appoint a liquidator, detail his responsibilities and powers, and define his compensation. Liquidation provisions often are thought of by draftsmen merely as “boilerplate.” These provisions can turn out to be some of the most important and most contentious provisions in your partnership agreement if issues are not addressed carefully. These provisions should address setting up, size of, and disposition of reserves, plus the final payment of unused reserves to partners. These provisions might address sources of funds if additional funds are needed to complete the liquidation. The liquidation provisions should set forth a clear scheme for how the proceeds of liquidation are distributed.

A more sophisticated agreement might address issues such as:

- Disposition of partnership intangible assets (including (without prejudice to generality) name, goodwill, and other intangible rights),
- Division of business opportunities derived from the partnership,
- Collections from past clients that continue with one of the partners or a successor firm,
- Compensation to the partnership for partially completed work,
- Retention of records and post-liquidation custody of partnership files, and

756 Treas. Reg. § 1.704-1(b)(2)(ii)(g) (quoted in note 1045) has an unusually broad standard of liquidation. It is unlikely that you want the partnership to go into winding up and liquidation on all of these events.
• Disposition or storage of client or business files.

The liquidation provisions might address conduct and funding of post-liquidation litigation if there is any.\textsuperscript{757}

---

\textsuperscript{757} The beginning of the winding up process is the “dissolution” of the partnership. The dissolution of a partnership is the change in the relationship of the partners caused by any partner ceasing to be associated in the carrying on as distinguished from the winding up of a business. The partnership will continue until the winding up of the partnership business and affairs is completed and properties have been disposed of. Dissolution is the beginning of this process. Delaware Limited Liability Company Act Section 18-801 provides:

\textbf{§ 18-801. Dissolution.}

\textit{(a) A limited liability company is dissolved and its affairs shall be wound up upon the first to occur of the following:}

\begin{enumerate}
\item At the time specified in a limited liability company agreement, but if no such time is set forth in the limited liability company agreement, then the limited liability company has a perpetual existence;
\item Upon the happening of events specified in a limited liability company agreement;
\item Unless otherwise provided in a limited liability company agreement, upon the affirmative vote or written consent of the members of the limited liability company or, if there is more than 1 class or group of members, then by each class or group of members, in either case, by members who own more than two-thirds of then-current percentage or other interest in the profits of the limited liability company owned by all of the members or by the members in each class or group, as appropriate;
\item At any time there are no members; provided, that the limited liability company is not dissolved and is not required to be wound up if:
\begin{enumerate}
\item Unless otherwise provided in a limited liability company agreement, within 90 days or such other period as is provided for in the limited liability company agreement after the occurrence of the event that terminated the continued membership of the last remaining member, the personal representative of the last remaining member agrees in writing to continue the limited liability company and to the admission of the personal representative of such member or its nominee or designee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member; provided, that a limited liability company agreement-
\end{enumerate}
\end{enumerate}
ment may provide that the personal representative of the last remaining member shall be obligated to agree in writing to continue the limited liability company and to the admission of the personal representative of such member or its nominee or designee to the limited liability company as a member, effective as of the occurrence of the event that terminated the continued membership of the last remaining member, or

b. A member is admitted to the limited liability company in the manner provided for in the limited liability company agreement, effective as of the occurrence of the event that terminated the continued membership of the last remaining member, within 90 days or such other period as is provided for in the limited liability company agreement after the occurrence of the event that terminated the continued membership of the last remaining member, pursuant to a provision of the limited liability company agreement that specifically provides for the admission of a member to the limited liability company after there is no longer a remaining member of the limited liability company.

(5) The entry of a decree of judicial dissolution under § 18-802 of this title.

(b) Unless otherwise provided in a limited liability company agreement, the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution.

Delaware Limited Liability Act Section 18-802 provides:

§ 18-802. Judicial dissolution. On application by or for a member or manager the Court of Chancery may decree dissolution of a limited liability company whenever it is not reasonably practicable to carry on the business in conformity with a limited liability company agreement.

Delaware Limited Liability Company Act Section 18-803 provides:

§ 18-803. Winding up.

(a) Unless otherwise provided in a limited liability company agreement, a manager who has not wrongfully dissolved a limited liability company or, if none, the members or a person approved by the members or, if there is more than 1 class or group of members, then by each class or group of members, in either case, by members who own more than 50 percent of then current percentage or other interest in the profits of the limited liability company owned by all of the members or by the members in each class or group, as appropriate, may wind up the limited liability company agreement.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

company’s affairs; but the Court of Chancery, upon cause shown, may wind up the limited liability company’s affairs upon application of any member or manager, the member’s or manager’s personal representative or assignee, and in connection therewith, may appoint a liquidating trustee.

(b) Upon dissolution of a limited liability company and until the filing of a certificate of cancellation as provided in § 18-203 of this title, the persons winding up the limited liability company’s affairs may, in the name of, and for and on behalf of, the limited liability company, prosecute and defend suits, whether civil, criminal or administrative, gradually settle and close the limited liability company’s business, dispose of and convey the limited liability company’s property, discharge or make reasonable provision for the limited liability company’s liabilities, and distribute to the members any remaining assets of the limited liability company, all without affecting the liability of members and managers and without imposing liability on a liquidating trustee.

Delaware Limited Liability Company Act Section 18-804 provides:

§ 18-804. Distribution of assets.
(a) Upon the winding up of a limited liability company, the assets shall be distributed as follows:

1. To creditors, including members and managers who are creditors, to the extent otherwise permitted by law, in satisfaction of liabilities of the limited liability company (whether by payment or the making of reasonable provision for payment thereof) other than liabilities for which reasonable provision for payment has been made and liabilities for distributions to members and former members under § 18-601 or § 18-604 of this title;

2. Unless otherwise provided in a limited liability company agreement, to members and former members in satisfaction of liabilities for distributions under § 18-601 or § 18-604 of this title; and

3. Unless otherwise provided in a limited liability company agreement, to members first for the return of their contributions and second respecting their limited liability company interests, in the proportions in which the members share in distributions.

(b) A limited liability company which has dissolved:

1. Shall pay or make reasonable provision to pay all claims and obligations, including all contingent, conditional or unmatured contractual claims, known to the limited liability company;

2. Shall make such provision as will be reasonably likely to be sufficient to provide compensation for any claim against the company.

(footnote continued on the next page)
limited liability company which is the subject of a pending action, suit or proceeding to which the limited liability company is a party; and

(3) Shall make such provision as will be reasonably likely to be sufficient to provide compensation for claims that have not been made known to the limited liability company or that have not arisen but that, based on facts known to the limited liability company, are likely to arise or to become known to the limited liability company within 10 years after the date of dissolution.

If there are sufficient assets, such claims and obligations shall be paid in full and any such provision for payment made shall be made in full. If there are insufficient assets, such claims and obligations shall be paid or provided for according to their priority and, among claims of equal priority, ratably to the extent of assets available therefor. Unless otherwise provided in the limited liability company agreement, any remaining assets shall be distributed as provided in this chapter. Any liquidating trustee winding up a limited liability company’s affairs who has complied with this section shall not be personally liable to the claimants of the dissolved limited liability company by reason of such person’s actions in winding up the limited liability company.

(c) A member who receives a distribution in violation of subsection (a) of this section, and who knew at the time of the distribution that the distribution violated subsection (a) of this section, shall be liable to the limited liability company for the amount of the distribution. For purposes of the immediately preceding sentence, the term “distribution” shall not include amounts constituting reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program. A member who receives a distribution in violation of subsection (a) of this section, and who did not know at the time of the distribution that the distribution violated subsection (a) of this section, shall not be liable for the amount of the distribution. Subject to subsection (d) of this section, this subsection shall not affect any obligation or liability of a member under an agreement or other applicable law for the amount of a distribution.

(d) Unless otherwise agreed, a member who receives a distribution from a limited liability company to which this section applies shall have no liability under this chapter or other applicable law for the amount of the distribution after the expiration of 3 years from the date of the distribution unless an action to recover the distribution from such member is commenced prior to the expiration of the said 3-year period and an adjudication of liability against such member is made in the said action.

(footnote continued on the next page)
97. **Put-Call Provision.**

Partnership agreements frequently contain buy-sell provisions in order to break deadlocks among partners. This is a short-form buy-sell provision:

_x.x Buy-Sell Provisions._

(a) **Put/Call.** Either the Managing Member or the *** Member (the party giving the notice are referred to as the “Initiating Member”) may give written notice (the “Offering Notice”) to the other (the “Responding Member”) of the Offering Member’s intent to rely on this Section x.x(a) and to purchase all (but not less than all) of the Responding Member’s Membership Interests at any time at least five (5) business days after the failure of—

(i) The Managing Members’ to obtain approval of a Unanimous Vote of the Members for any matter requiring approval of a Unanimous Vote of the Member under Section y.y of this Agreement or

(ii) The Members to reach unanimous agreement upon any matter requiring unanimous approval of the Members under Section z.z of this Agreement.

(b) **Negotiation Period; Appraisal.**

(i) The Responding Member and the Initiating Member shall attempt diligently to agree upon the Liquidation Value upon the Responding Member’s receipt of the Offering Notice from the Initiating Member.

(ii) The Initiating Member (on the one hand) and the Responding Member (on the one other) shall each (within five (5) business days thereafter) appoint (by written notice to each other) an M.A.I. accredited real estate appraiser (who has been active over the five (5) year period ending on the date of the appointment in the Pitkin County, Colorado, real estate market) if an agreement on the Liquidation Value is not reached within ten (10) business days after the Offering Notice is delivered to the Responding Member.

(iii) The two appraisers each shall prepare a written appraisal of the Liquidation Value and submit their written appraisals to

(e) Section 18-607 of this title shall not apply to a distribution to which this section applies.
the Initiating Member and the Responding Member (who shall promptly meet to compare the two appraisals).

(iv) If the Liquidation Values determined by the two appraisers differ by less than ten percent (10%) of the higher of the two, the arithmetic average of the two appraisals (the sum of the two appraisals divided by two) shall be the Liquidation Value for purposes of this Section.

(v) If the Liquidation Values determined by the two appraisers differ by ten percent (10%) or more of the higher of the two, then the two appraisers (within five (5) business days after the comparison of the two appraisals is conducted) shall appoint a third M.A.I. accredited real estate appraiser (who has been active over the five (5) year period ending on the date of the appointment in the Pitkin County, Colorado, real estate market).

(vi) The three (3) appraisers shall meet to determine the Liquidation Value.

(vii) If either of the Initiating Member or the Responding Member (as applicable) fails to select an appraiser (within the five (5) day period), the appraiser appointed by the other party shall determine the Liquidation Value.

(viii) The Liquidation Value shall equal the arithmetic average of the Liquidation Values determined by each of the two appraisers whose appraisals are closest to each other. The Liquidation Value, however, shall equal the middle appraisal, if the highest and lowest appraisals are equidistant from the middle appraisal. The Liquidation Value shall be the value determined by the appraiser appointed by the other party if the Initiating Member or the Responding Member (as applicable) fails to timely appoint its appraiser as provided above.

(ix) In connection with any appraisal under this Section (b),

---

758 This clarifies that the “average” to which the partnership agreement refers is not the geometric average.

759 Some partnership agreements refer to the two closest appraisals of three appraisals. They often provide no guidance where two appraisals are equidistant from the third.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(A) The Initiating Member shall bear one hundred percent (100%) of the fees and costs charged by the appraiser appointed by the Initiating Member,

(B) The Responding Member shall bear one hundred percent (100%) of the fees and costs charged by the appraiser appointed by the Responding Member and

(C) The Company shall bear one hundred percent (100%) of the fees and costs charged by the third appraiser.

c) Election Notice.

(i) Within five (5) business days following the determination of the Liquidation Value, the Responding Member shall notify the Initiating Member (the notice is referred to as an “Election Notice”) of its intent either –

(A) To sell all (but not less than all) of the Responding Member’s Membership Interest to the Initiating Member at an all-cash purchase price equal to the aggregate Buy-Out Price or

(B) To purchase all (but not less than all) of the Initiating Member’s Membership Interest at an all-cash purchase price equal to the aggregate Buy-Out Price of the Initiating Member.

(ii) Failure by the Responding Member to give notice within the required time period, shall constitute an election by the Responding Member to sell the Responding Member’s Membership Interest for the Buy-Out Price determined in accordance with this Section x.x.

(iii) For purposes of this Section x.x, “Purchasing Member” means the Member who is obligated to purchase the other Member’s Membership Interests under this Section x.x (whether the Member is the Initiating Member or the Responding Member).

(iv) “Selling Member” means the Member who is obligated to sell its Membership Interest to the Purchasing Member.

d) Closing.

(i) The Members shall meet and shall exchange documents and shall pay any amounts due, and otherwise shall do all things necessary to conclude the transaction set forth in this Section x.x at the closing of the purchase (the “Put/Call Closing”).

(ii) The Put/Call Closing shall occur at the office of the Purchasing Member’s legal counsel at 1:00 p.m., or at another place and time as may be agreed between the Purchasing Member and the Selling
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Member, on the first Wednesday after the election in Section x.x(c) (unless that day is a national or state holiday in Pitkin County, Colorado, and, in that event, on the next business day).

(iii) At the Put/Call Closing,

(A) The Selling Member shall deliver to the Purchasing Member a duly executed assignment of its Membership Interest.

(B) The Selling Member shall (upon the request of the Purchasing Member) (concurrently therewith or at any time) execute and deliver the other documents and Company records as the Purchasing Member determines are necessary or desirable to conclude the Put/Call Closing and to transfer ownership, title and control of the Company assets (including (without prejudice to generality) execution, in recordable form, of an amended certificate of formation and/or cancellation of certificate of formation).

(C) The Purchasing Member shall deliver to the Selling Member in immediately available funds (in United States dollars) the full amount of the consideration (if any) for the Membership Interest that is sold.

(D) The Purchasing Member shall deliver any other documents necessary from the Purchasing Member to conclude the Put/Call Closing.

(iv) The Selling Member shall transfer its Membership Interests free of all liens or encumbrances (except for any liens or encumbrances in favor of the Company or any of the Purchasing Members).

(v) On the Put/Call Closing, the Selling Member and/or its Affiliates shall be released from liability under any third party loans to the Company and any guarantees and/or indemnities made in connection therewith. This release shall be a condition to close in favor of the Selling Member. If a Company creditor refuses to release the Selling Member and/or its Affiliates, the Purchasing Member shall indemnify the Selling Member from liability under any third party loans to the Company and any guarantees and/or indemnities made in connection therewith.

(e) Failure to Close. The Purchasing Member’s failure to close as described above shall be an Event of Default under this Agreement by the Purchasing Member (within the meaning of Section z.z). In addition to any other remedies available under this Agreement, the Selling Member has the right to purchase under this Section x.x the Membership Interest of the Purchasing Member for consideration computed in accordance with
this Section x.x. This right is exercisable by written notice to the Purchasing Member (given within ten (10) business days of the date set for the Put/Call Closing).

(f) Fair Market Value. For purposes of this Section x.x, “Fair Market Value” of the Property means the amount that the Company could reasonably anticipate receiving in a transaction if the Property was sold at a price that would be obtained in an arm’s length transaction (where the Property was exposed to the market for a reasonable period of time) between an informed and willing buyer and seller (in either case under no compulsion to enter into the transaction and neither of which is related to any Member (or any Affiliate thereof)), considering the sales price for similar properties in the Pitkin County, Colorado, market sold within the previous twelve (12) month period and adjustments for factors as may be relevant to the determination of the Property’s Fair Market Value as the appraiser(s) deem(s) necessary or appropriate.

(g) Liquidation Value. For purposes of this Section x.x, “Liquidation Value” means the excess of—

(i) The gross proceeds that would have been received by the Company if the Company sold (on the date the Offering Notice was delivered) the Property and all of its other assets at their then Fair Market Value payable in immediately available funds (in United States dollars) at closing, over

(ii) All estimated hypothetical costs and expenses of sale of the Property and liquidation of the Company, all liabilities of the Company, and a reasonable reserve for the contingent liabilities of the Company (without duplication for items that shall have reduced Fair Market Value). For this purpose, “expenses of sale” include including (without prejudice to generality) closing costs, real estate brokerage commissions and fees, title insurance premiums and escrow fees, transfer or conveyance taxes, and legal, accounting, and other expenses incident to the sale and liquidation.

(h) Buy-Out Price. For purposes of this Section x.x, “Buy-Out Price” means (with respect to any Member) the excess of—
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(i) The amount that the Member would have been entitled to receive under this Agreement on the liquidation of the Company if the Company had distributed (on the date the Offering Notice was delivered) to its Member in liquidation of the Company the amount of the Liquidation Value, over

(ii) Any distributions received by the Member since the date the Offering Notice was delivered to the Responding Member.


Section x.x. Like-Kind Exchange Option.

(a) If there is a sale of the Property and upon the request of either Partner, the other Partner, the General Partner and the Partnership shall cooperate in a tax-deferred exchange pursuant to Section 1031 of the Code arranged by the Partner requesting this exchange as a means to avoid a taxable sale of the Property.

(b) This exchange may include distribution of an undivided interest in the Property, subject to a portion of any existing indebtedness with respect thereto, in order to facilitate an exchange by the requesting Partner of this Property.

(c) If there is a request to conduct a tax-deferred exchange in accordance with this Section x.x, the Partnership shall cause to be included in the purchase and sale agreement for the Property provisions obligating the purchaser to cooperate in connection with a Section 1031 exchange arranged by the Partnership or the requesting Partner and the Partnership shall provide the requesting Partner reasonable prior notice of this sale.

(d) Upon the request of the Partner seeking a tax-deferred exchange pursuant to Section 1031 of the Code, the Partnership, the General Partner and the other Partner shall use commercially reasonable efforts to cooperate with the requesting Partner to complete a like-kind exchange of the Property (in accordance with Section 1031 of the Code) for replacement property to be identified exclusively by the requesting Partner.

(e) Immediately prior to this disposition of the Property (but conditioned upon the substantially simultaneous consummation thereof) and the distribution to the Partners of any proceeds of this sale, the Partnership shall distribute to the requesting Partner (in complete retirement of the requesting Partner’s interest in the Partnership) an undivided inter-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

est in the Property equal in value to the amount that the requesting Partner would receive in liquidation of the Partnership if the Partnership had sold the Property for cash to the grantee of the Property in this purchase and for consideration set forth in the purchase and sale agreement, and the Partnership had thereupon been liquidated.

(f) The requesting Partner shall proceed to exchange the undivided interest at the same time as the Partnership shall sell its retained interest in the Property to the purchaser. Each shall receive a pro rata share of the net consideration for the Property.

(g) Notwithstanding the foregoing, the Partnership’s, the General Partner’s and the other Partners’ obligations to cooperate with the requesting Partner to complete a like-kind exchange of the Property in accordance with Section 1031 of the Code shall be subject to these restrictions and terms:

(i) The Partnership, the General Partner and/or the other Partner shall not make any representations to the requesting Partner regarding qualification of the exchange under Section 1031 of the Code. None of them shall be liable to the requesting Partner in any manner whatsoever if the exchange fails to qualify for any reason under Section 1031 of the Code;

(ii) This exchange shall not delay the closing of the sale of the Property;

(iii) The requesting Partner alone shall bear any costs, expenses and liabilities incurred by the Partnership, the General Partner or the other Partner in connection with any this exchange that would not have been incurred in the absence of this exchange; and

(iv) The non-requesting Partner has no other obligation or liability associated with this exchange (except for the requirement reasonably to cooperate in any this exchange as required by this Agreement).

Partnership agreements often require that the sale of the partnership property be structured to allow individual partners to undertake Section 1031 exchanges. The wisdom of agreeing to the provision is left to you and your client. There are many difficult tax issues that have not been decisively resolved. These issues are outside of the scope of this Article. A more general clause will create greater ambiguity than a more specific clause. There may be uncertainty whether an exchange under this clause will qualify for nonrecognition under Section 1031.

Many issues that are not dealt with properly in the proposed exchange clause. Among other issues, consider drafting to address these issues:
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Does the new tenant-in-common partner become a party to the purchase and sale agreement?
- Does the new tenant-in-common partner become a party to the escrow agreement?
- Does the new tenant-in-common partner become a party to representations and warranties on the property?
- Does the new tenant-in-common partner have selective liability on representations and warranties?
- Is liability joint or several?
- Does the new tenant-in-common partner have liability on organizational and authority representations and warranties of the partnership?
- Will the new tenant-in-common partner be prepared to make final certifications with respect to the property (for example, certification of the accuracy of rent rolls, lease summaries, supplier and contract lists, etc.)
- What happens if the sale does not close?
- What happens if the sale is delayed?
- What happens if the new tenant-in-common partner becomes bankrupt?
- What happens if the new tenant-in-common partner becomes uncooperative after the tenant-in-common interest is distributed to him?
- What happens if the new tenant-in-common partner refuses to sign consents?
- What happens if the exchange is audited? Who bears the audit expense? Who controls the audit? The exchange might be challenged in a TEFRA audit of the partnership, with the partnership having to bear all of the audit expense.
- Should the relinquished property for the exchange be distributed to the exchanging partner, or should the exchanging partner be left with the partnership, with continuing partners receiving distributions of the property in which they will continue to own an ownership interest?

Will the exchange qualify under Section 1031? Although the proposed clause describes a common transaction, it is replete with unresolved tax issues. The exchange should be considered a high risk exchange. The issues include:
• Will the distribution to the partner be respected for federal income tax purposes?

• Will the partner be treated as satisfying the investment intent requirement of Section 1031?

There is a substantial body of literature discussing what are commonly referred to as “drop and swap exchanges.” The partnership rather than the partner might be treated as the selling party for tax purposes. This conclusion could be justified under the theory that the purported distribution does not effectively break up the tax partnership, the step transaction doctrine, the sham doctrine, the business purpose doctrine, or any of a variety of other theories. Alternatively, the partner might not be treated as establishing that he has the requisite investment intent with respect to the partnership’s property.

99. Registered Office and Agent.

Delaware law says that each LLC formed in Delaware will maintain within the state of Delaware: (1) a registered office (which may but need not be a place of its business in the State of Delaware); and (2) a registered agent for service of process on the limited liability company. Both should be set forth in the operating agreement. This is a typical provision:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING 
PARTNERSHIP AND LLC AGREEMENTS AND 
SOME BASIC ISSUES IN 
DRAFTING REAL ESTATE 
PARTNERSHIP AND LLC AGREEMENTS

Section x.x. Registered Office and Agent; Principal Office.
(a) The address of the registered office of the Company in the 
State of Delaware is ***** (until changed by the Manager).
(b) The name and address of the registered agent for service of 
process on the Company is ***** (until changed by the Manager).\(^\text{760}\)

100. Fictitious Business Certificate.
The partnership agreement might direct the managers to file and publish 
required fictitious business certificates. This is a typical provision addressing this 
issue:

Section x.x. Conduct of Business in Other Jurisdictions. When and as 
necessary (in the Manager’s sole and absolute discretion) (a) the Mana-
ger shall cause a Fictitious Business Name Statement for the Company to 
be filed and published in Lake County, California, pursuant to the Busi-
ness and Professions Code of California; and (b) the Manager shall cause 
to be prepared and filed such other documents and instruments as may be 
necessary to the conduct of the business of the Company. Upon the acqui-
sition by the Company of any real property or other assets in any jurisdi-
ction, the Manager shall prepare, sign and cause to be filed and recorded 
such filings, certificates, registrations, statements and other instruments 
as may be necessary or appropriate to the acquisition of the real property 
and/or assets and to the transaction of business by the Company in each 
jurisdiction.

\(^{760}\) See Delaware Limited Liability Company Act § 18-104(a) (“(a) Each lim-
ited liability company shall have and maintain in the State of Delaware: (1) A reg-
istered office, which may but need not be a place of its business in the State of 
Delaware; and (2) A registered agent for service of process on the limited liability 
company, which agent may be any of: a. The limited liability company itself, b. 
An individual resident in the State of Delaware, c. A domestic limited liability 
company (other than the limited liability company itself), a domestic corporation, 
a domestic partnership (whether general (including a limited liability partnership) 
or limited (including a limited liability limited partnership)), or a domestic statu-
tory trust, or d. A foreign corporation, a foreign partnership (whether general (in-
cluding a limited liability partnership) or limited (including a limited liability lim-
ited partnership)), a foreign limited liability company, or a foreign statutory trust. 
* * * *”) (effective January 1, 2007).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS


The partnership agreement might direct the managers to qualify to do business in states in which the partnership conducts business or owns assets. This is a simple provision addressing this issue:

Section x.x. Qualification. The Company shall qualify to do business in each jurisdiction in which qualification is required.

102. Business Transactions with the Partnership.

Delaware law, for example, says:

Except as provided in a limited liability company agreement, a member or manager may lend money to, borrow money from, act as a surety, guarantor or endorser for, guarantee or assume 1 or more obligations of, provide collateral for, and transact other business with, a limited liability company and, subject to other applicable law, has the same rights and obligations with respect to any such matter as a person who is not a member or manager.761

A partnership agreement should address whether partners are free to make loans to the partnership or any limitations that the partnership agreement should impose. Clearly delineate what business transactions between a partner (or a manager) and the partnership are permitted and what business transactions are not permitted. Clarify what approval is required for related-party transactions. There may be, for example, a requirement of approval of the transaction by a majority of disinterested partners. Consider requiring that related-party transactions be undertaken on fair market value terms consistent with those normally available to third parties in the market.

There is not a unique solution for all partnership agreements. A partnership agreement may prohibit all self-dealing transactions between partners (or managers) and the partnership. A partner may have an affiliate that is best suited to provide property or services to the partnership (for example, a management or construction company).

761 Delaware Limited Liability Company Act § 18-107.
103. Standard of Care.

Section x.x. Standard of Care. Neither the Managers nor any Member or officer of the Company has any personal liability whatsoever to the Company or to any Member of the Company or to any Affiliate or constituent owner of any Member on account of this Person’s status as a Manager, Member or officer of the Company or by reason of this Person’s acts or omissions in connection with the conduct of the business of the Company so long as this Person—

(a) Acts in good faith for a purpose that the Person reasonably believes to be in (or not opposed to) the best interests of the Company; and

(b) Has no reasonable cause to believe that this Person’s conduct was unlawful.

The immediately previous sentence is qualified by the limitation that nothing contained in this Agreement shall protect this Person against any liability to which this Person would otherwise be subject by reason of—

(c) Any act or omission of this Person that involves actual fraud or willful misconduct, gross negligence, reckless disregard of duty or a material breach of this Agreement;

(d) Any act or omission that was part of any transaction from which this Person derives any improper personal benefit.

Clarify the standard of care to be used by partners and managers in acting for the partnership. Partners and managers may be required to act reasonably, or they may merely be required to act in good faith. Some partnership agreements confuse the different standards and require partners and managers to act “reasonably and in good faith.” The standard of care is an important protection against misbehavior, grossly negligent behavior, or negligent behavior by a partner. Do not automatically accept a lower standard of care, especially if you are a passive investor who will receive the benefit of holding the manager or other partners to a higher standard of care. Your partnership agreement should clearly set forth the standard of care to which the manager or general partner will be held.

104. Standard of Discretion.

Section x.x. Discretion of the Manager; Limitation of Liability. The Manager shall be free to exercise his sole and absolute discretion in making any and all decisions relating to the conduct of the Company’s business or otherwise delegated to the Manager by any provision of this
AGREEMENT. The Manager shall not be liable (in respect of any decision) to the Company, the Members or any of their respective Affiliates or constituent owners for any resulting actual or alleged losses, damages, costs or expenses suffered by them so long as –

(a) The decision was made by the Manager in good faith for a purpose believed by him to be in, or not opposed to, the best interests of the Company;

(b) The decision did not involve actual fraud or willful misconduct, gross negligence, reckless disregard of duty or a material breach of this Agreement;

(c) The decision was not part of any transaction from which this Person derives any improper personal benefit.

Clarify the standard of discretion to be applied when decisions are made in the discretion of a partner or manager. Decisions often are subject to the standard of reasonableness or the standard of good faith. Your partnership agreement should not permit a partner’s decision to be wholly arbitrary and to be made in bad faith. The duty of good faith and fair dealing (or contractual covenant of good faith and fair dealing) cannot be waived. Consider whether you are willing to

---

The precise contours of this duty of good faith and fair dealing are not delineated by statute. Section 205 of the Restatement (Second) of Contracts Second states that “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” As a general matter, the covenant of good faith and fair dealing requires that a partnership manager act fairly, and not be arbitrary and capricious in his exercise of powers. The covenant requires that a manager not exercise his powers with an intent to harm another partner and in a manner not reasonably expected from the relationship among the parties. The manager should not exercise his powers in a manner that is inconsistent with reasonable expectations in the context of the relationship. Good faith implies honesty in conduct. The manager should exercise good faith by not taking advantage of ambiguities in the partnership agreement in such a manner as to act unfairly and in a manner contrary to normal reasonable business expectations. The covenant of good faith and fair dealing is breached if the manager acts in bad faith and with oppression and malice to the other partners in exercising his powers as manager. The covenant of good faith and fair dealing permits a court to take into account circumstances, defenses, and considerations of fairness and ordinary behavior and expectations that are not necessarily explicitly set forth in the written partnership agreement. The covenant implies an overriding standard of honest, loyal and considerate behavior, a standard of acting with due regard for the interests of the oth-

(footnote continued on the next page)
accept a good faith standard of discretion (a low standard) from another partner. This gives the partner broad discretion. A partner with discretion to approve a policy or act subject to the partner’s good faith judgment usually has little difficulty justifying his disapproval.

105. Fiduciary Duties.

Section x.x. Fiduciary Duties. To the fullest extent permitted by Delaware law, no Member or Manager has fiduciary duties with respect to the Company or any other Member or Manager, and to the extent that, at law or in equity, a Member, Manager or officer of the Company has duties or obligations to the Company or to Member, Manager or other Person who is a party to this Agreement, that Member, Manager or officer of the Company shall not be liable to the Company or to any such other Member, Manager or Person for its good faith reliance on this Agreement.

Such a broad waiver of fiduciary duties is dangerous.

Your partnership agreement can help to clarify or to limit the fiduciary duties of partners. Be careful in modifying or limiting fiduciary duties. Fiduciary duties provide noncontrolling partners with important protections. Waiver and modification of fiduciary duties inherently relies on state law. Take nuances of state law into consideration.

This is another example:

Section x.x. Fiduciary Duties. Except as otherwise provided in this Agreement, no Member has any fiduciary obligations with respect to the Company or to the other Members insofar as making any investment or
other opportunity or opportunities available to the Company or to the other Members. Each Member may engage in whatever activities the Member may choose (except as otherwise limited in this Agreement) without having or incurring any obligation to offer any interest in the activities to the Company or to the other Members. This applies whether the activities are competitive with the Company or otherwise. The fiduciary duties of each Member shall be limited solely to those arising from the activities described in Section y.y above. Notwithstanding the foregoing, each Member and their Affiliates shall be required to offer to the Company each and every opportunity that the Member and their Affiliates acquires after the date of this Agreement to pursue a prospective business venture if, by its nature, that prospective venture –

(a) Is within the primary purpose of the Company specified in Section y.y above;

(b) Directly relates the business of the Company; and

(c) Is a venture that the Company would reasonably be in a position to take up in the ordinary course of its business;

The immediately previous sentence is qualified by the limitation that no Member or its Affiliates shall be under any obligation to cause any Person to take up any prospective business venture with the Company.

Fiduciary duties differ appreciably from state to state. Delaware law, for example, permits expanding on restricting fiduciary duties to a limited liability company. The operating agreement, however, may not eliminate the implied contractual covenant of good faith and fair dealing. Further, the operating agreement may limit or eliminate liabilities for breach of contract or breach of duties. The operating agreement, however, may not eliminate liability for bad faith violation of the implied covenant of good faith and fair dealing.

763 Delaware Limited Liability Company Act § 18-1101(c) (“To the extent that, at law or in equity, a member or manager or other person has duties (including (without prejudice to generality) fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”).

764 Delaware Limited Liability Company Act § 18-1101(e) ("A limited liability company agreement may provide for the limitation or elimination of any and (footnote continued on the next page)
The only fiduciary duties that a partner owes to a general partnership and the other partners under the Uniform Partnership Act are the duty of loyalty and the duty of care. (The covenant of good faith and fair dealing creates additional obligations, but is generally not considered a fiduciary duty.)

These duties are set forth in Section 404 of the Uniform Partnership Act:

- **(b)** A partner’s duty of loyalty to the partnership and the other partners is limited to the following:
  1. to account to the partnership and hold as trustee for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or derived from a use by the partner of partnership property including the appropriation of a partnership opportunity;
  2. to refrain from dealing with the partnership in the conduct or winding up of the partnership business as or on behalf of a party having an interest adverse to the partnership; and
  3. to refrain from competing with the partnership in the conduct of the partnership business before the dissolution of the partnership.
- **(c)** A partner’s duty of care to the partnership and the other partners in the conduct and winding up of the partnership business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.
- **(d)** A partner shall discharge the duties to the partnership and the other partners under this [Act] or under and exercise any rights consistently with the obligation of good faith and fair dealing.
- **(e)** A partner does not violate a duty or obligation under this [Act] or under the partnership agreement merely because the partner’s conduct furthers the partner’s own interest.
- **(f)** A partner may lend money to and transact other business with the partnership, and as to each loan or transaction the rights and obligations of the partner are the same as those of a person who is not a partner, subject to other applicable law.

(footnote continued on the next page)
Section 103(a)(3)-(5) of the Uniform Partnership Act (1997) provides that the partnership agreement may not eliminate the duty of loyalty. It may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable. The partnership agreement may specify the note to authorize or ratify (after full disclosure of all material facts) a specific act or transaction that otherwise would violate the duty of loyalty. The agreement may not unreasonably reduce the duty of care. The agreement also may not eliminate the obligation of good faith and fair dealing.\textsuperscript{766}

(g) This Section applies to a person winding up the partnership business as the personal or legal representative of the last surviving partner as if the person were a partner. Section 103(a)(3)-(5) of the Uniform Partnership Act (1997) provides that the partnership agreement may not—

(3) eliminate the duty of loyalty under Section 404(b) or 603(b)(3), but:

(i) the partnership agreement may identify specific types or categories of activities that do not violate the duty of loyalty, if not manifestly unreasonable; or

(ii) all of the partners or a number or percentage specified in the partnership agreement may authorize or ratify, after full disclosure of all material facts, a specific act or transaction that otherwise would violate the duty of loyalty;

(4) unreasonably reduce the duty of care under Section 404(c) or 603(b)(3);

(5) eliminate the obligation of good faith and fair dealing under Section 404(d), but the partnership agreement may prescribe the standards by which the performance of the obligation is to be measured, if the standards are not manifestly unreasonable; . . . .

Official comments clarify that:

Subsection (b)(3) through (5) are intended to ensure a fundamental core of fiduciary responsibility. Neither the fiduciary duties of loyalty or care, nor the obligation of good faith and fair dealing, may be eliminated entirely. However, the statutory requirements of each can be modified by agreement, subject to the limitation stated in subsection (b)(3) through (5).

There has always been a tension regarding the extent to which a partner’s fiduciary duty of loyalty can be varied by agreement, as contrasted with the other partners’ consent to a particular and known breach of duty. On the one hand, courts have been loathe to enforce agreements broadly “waiving” in advance a partner’s fiduciary duty of loyalty, especially (footnote continued on the next page)
where there is unequal bargaining power, information, or sophistication. For this reason, a very broad provision in a partnership agreement in effect negating any duty of loyalty, such as a provision giving a managing partner complete discretion to manage the business with no liability except for acts and omissions that constitute willful misconduct, will not likely be enforced. [Citations omitted.] On the other hand, it is clear that the remaining partners can “consent” to a particular conflicting interest transaction or other breach of duty, after the fact, provided there is full disclosure.

RUPA attempts to provide a standard that partners can rely upon in drafting exculpatory agreements. It is not necessary that the agreement be restricted to a particular transaction. That would require bargaining over every transaction or opportunity, which would be excessively burdensome. The agreement may be drafted in terms of types or categories of activities or transactions, but it should be reasonably specific.

A provision in a real estate partnership agreement authorizing a partner who is a real estate agent to retain commissions on partnership property bought and sold by that partner would be an example of a “type or category” of activity that is not manifestly unreasonable and thus should be enforceable under the Act. Likewise, a provision authorizing that partner to buy or sell real property for his own account without prior disclosure to the other partners or without first offering it to the partnership would be enforceable as a valid category of partnership activity.

Ultimately, the courts must decide the outer limits of validity of such agreements, and context may be significant. It is intended that the risk of judicial refusal to enforce manifestly unreasonable exculpatory clauses will discourage sharp practices while accommodating the legitimate needs of the parties in structuring their relationship.

5. Subsection (b)(3)(i) permits the partners, in their partnership agreement, to identify specific types or categories of partnership activities that do not violate the duty of loyalty. A modification of the statutory standard must not, however, be manifestly unreasonable. This is intended to discourage overreaching by a partner with superior bargaining power since the courts may refuse to enforce an overly broad exculpatory clause. [Citations omitted.]

Subsection (b)(3)(ii) is intended to clarify the right of partners, recognized under general law, to consent to a known past or anticipated violation of duty and to waive their legal remedies for redress of that violation. This is intended to cover situations where the conduct in question is not specifically authorized by the partnership agreement. It can also be used (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The Delaware Limited Liability Company Act does not specifically detail the fiduciary duties owed to the limited liability company. The Uniform Limited Liability Company Act (generally superseded by the Revised Uniform Limited Liability Company Act\(^767\)), however, in a provision not adopted in Delaware, says

to validate conduct that might otherwise not satisfy the “manifestly unreasonable” standard. Clause (ii) provides that, after full disclosure of all material facts regarding a specific act or transaction that otherwise would violate the duty of loyalty, it may be authorized or ratified by the partners. That authorization or ratification must be unanimous unless a lesser number or percentage is specified for this purpose in the partnership agreement.

6. Under subsection (b)(4), the partners’ duty of care may not be unreasonably reduced below the statutory standard set forth in Section 404(d), that is, to refrain from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

For example, partnership agreements frequently contain provisions releasing a partner from liability for actions taken in good faith and in the honest belief that the actions are in the best interests of the partnership and indemnifying the partner against any liability incurred in connection with the business of the partnership if the partner acts in a good faith belief that he has authority to act. Many partnership agreements reach this same result by listing various activities and stating that the performance of these activities is deemed not to constitute gross negligence or willful misconduct. These types of provisions are intended to come within the modifications authorized by subsection (b)(4). On the other hand, absolving partners of intentional misconduct is probably unreasonable. As with contractual standards of loyalty, determining the outer limit in reducing the standard of care is left to the courts.

The standard may, of course, be increased by agreement to one of ordinary care or an even higher standard of care.

7. Subsection (b)(5) authorizes the partners to determine the standards by which the performance of the obligation of good faith and fair dealing is to be measured. The language of subsection (b)(5) is based on UCC Section 1-102(3). The partners can negotiate and draft specific contract provisions tailored to their particular needs (for example, five days notice of a partners’ meeting is adequate notice), but blanket waivers of the obligation are unenforceable. [Citations omitted.]

\(^767\) The National Commissioners on Uniform Laws Adopted the Revised Uniform Limited Liability Company Act in July 2006.
that the only fiduciary duties in a limited liability company are the duties of loyalty and the duty of care.\footnote{Section 409 of the Uniform Limited Liability Company Act, provides: Section 409. General Standards Of Member’s And Manager’s Conduct. (a) The only fiduciary duties a member owes to a member-managed company and its other members are the duty of loyalty and the duty of care imposed by subsections (b) and (c). (b) A member’s duty of loyalty to a member-managed company and its other members is limited to the following: (1) to account to the company and to hold as trustee for it any property, profit, or benefit derived by the member in the conduct or winding up of the company’s business or derived from a use by the member of the company’s property including the appropriation of a company’s opportunity; (2) to refrain from dealing with the company in the conduct or winding up of the company’s business as or on behalf of a party having an interest adverse to the company; and (3) to refrain from competing with the company in the conduct of the company’s business before the dissolution of the company. (c) A member’s duty of care to a member-managed company and its other members in the conduct of and winding up of the company’s business is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law. (d) A member shall discharge the duties to a member-managed company and its other members under this [Act] or under the operating agreement and exercise any rights consistently with the obligation of good faith and fair dealing. (e) A member of a member-managed company does not violate a duty or obligation under this [Act] or under the operating agreement merely because the member’s conduct furthers the member’s own interest. (f) A member of a member-managed company may lend money to and transact other business with the company. As to each loan or transaction, the rights and obligations of the member are the same as those of a person who is not a member, subject to other applicable law. (g) This section applies to a person winding up the limited liability company’s business as the personal or legal representative of the last surviving member as if the person were a member. (h) In a manager-managed company: (footnote continued on the next page)}
Indemnification.

Section x.x  Indemnification.

(a)  The Partnership shall indemnify and shall hold harmless any Person (an “Indemnified Person”) made (or threatened to be made) a party to an action or proceeding (a “Proceeding”) by reason of the fact that the Indemnified Person was or is a Manager, a Partner, or an Affiliate of a Manager, a Partner or a trustee of a Partner or Manager, against all Liabilities incurred as a result of the Proceeding.

(b)  These rules and limitations apply to the indemnification in this Section x.x:

(i)  The indemnification in this Section x.x applies only if the Indemnified Person acted in good faith, for a purpose that this Person believed to be in (or not opposed to) the best interests of the Partnership and had no reasonable cause to believe that this Person’s conduct was unlawful.

(ii)  The indemnification in this Section x.x includes (without prejudice to generality) indemnification against active or passive negligence, or breach of duty.

(iii)  The indemnification in this Section x.x includes (without prejudice to generality) indemnification against acts undertaken in the capacity of the Tax Matters Partner.

(1)  a member who is not also a manager owes no duties to the company or to the other members solely by reason of being a member;

(2)  a manager is held to the same standards of conduct prescribed for members in subsections (b) through (f);

(3)  a member who pursuant to the operating agreement exercises some or all of the rights of a manager in the management and conduct of the company’s business is held to the standards of conduct in subsections (b) through (f) to the extent that the member exercises the managerial authority vested in a manager by this [Act]; and

(4)  a manager is relieved of liability imposed by law for violation of the standards prescribed by subsections (b) through (f) to the extent of the managerial authority delegated to the members by the operating agreement.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(iv) A “Proceeding” includes (without prejudice to generality) an action by or in the right of the Partnership.

(v) A “Proceeding” includes any action or proceeding whether civil, criminal or investigative.

(vi) “Reasonable expenses” include (without prejudice to generality) investigation, accounting and attorneys’ fees.

(vii) “Liabilities” include (without prejudice to generality) all judgments, fines, amounts paid in settlement and reasonable expenses.

(viii) The indemnification in this Section x.x includes Liabilities incurred in any appeal in the Proceeding.

(ix) The termination of any Proceeding by judgment, settlement, conviction or upon a plea of nolo contendere, or its equivalent, shall not in itself create a presumption that any Indemnified Person did not act in good faith, for a purpose that the Indemnified Person believed to be in (or not opposed to) the best interests of the Partnership or that the Indemnified Person had reasonable cause to believe that the Indemnified Person’s conduct was unlawful.

(x) The Partnership’s indemnification obligations under this Agreement shall survive the termination of the Partnership.

(xi) Each indemnified Person has a claim against the property and assets of the Partnership for payment of any indemnity amounts due under this Agreement. These amounts shall be paid or properly reserved for prior to the making of distributions by the Partnership to the Partners.

(xii) The right to indemnification conferred in this Section x.x shall be a contract right and shall include the right to require the Partnership to advance the expenses incurred by the Indemnified Person in defending any proceeding in advance of its final disposition.

(xiii) If the Act so requires, the payment of the expenses in advance of the final disposition of a Proceeding shall be made only upon receipt by the Partnership of an undertaking (by or on behalf of the Indemnified Person) to repay all amounts so advanced if it shall ultimately be determined that the Indemnified Person is not entitled to be indemnified under this Section x.x or otherwise.

(xiv) The right to indemnification and the payment of expenses incurred in defending a proceeding in advance of its final disposition conferred in this Section x.x shall not be exclusive of any other right
that any Person may have or hereafter acquire under any statute or agreement, or under any insurance policy obtained for the benefit of any indemnified Person.

(xv) The Company may purchase and maintain insurance on behalf of an indemnified Person (and for each indemnified Person who was a Member or officer of the Company for a reasonable period after ceasing to have this status) against any liability that may be asserted against that Person and incurred by that Person in any such capacity or arising out of that Person’s connection with the Company.

(xvi) In addition, the Company may purchase and maintain insurance on behalf of any other Person who is or was an employee, independent contractor or agent of the Company, and/or their officers, directors, shareholders, partners, members, managers, employees, independent contractors or agents, whether or not the Company would be required to indemnify that Person against liability under Section x.x or under applicable law.

Partners and managers and officers often are indemnified by the partnership, if they have acted in accordance with the standard of care required by your partnership agreement. Form agreements often are the departure point for long negotiations. The indemnification provisions require at least as much thought as any other part of your partnership agreement. The common law rules concerning indemnification of partners by the partnership (in the absence of a clear indemnification obligation in the partnership) appear currently to be in a state of flux.769

Indemnification rights often have recourse only to the partnership and its assets. Consider, however, whether there should be a claim against the former partners (to the extent of liquidating distributions) if the indemnification is made after the partnership has wound up and distributed its assets in liquidation.

A typical indemnification provision might indemnify “any Member, Manager, Tax Matters Partner or officer of the Company, an Affiliate of any Member, Manager, Tax Matters Partner or officer of the Company, or any officer, director,

769 For statutory rules, see Delaware Limited Liability Company Act § 18-108 (“Subject to such standards and restrictions, if any, as are set forth in its limited liability company agreement, a limited liability company may, and shall have the power to, indemnify and hold harmless any member or manager or other person from and against any and all claims and demands whatsoever.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

shareholder, partner, member, employee, manager or agent of any of the foregoing.” Another agreement might be more restrictive in who is indemnified.

Indemnifications may be heavily negotiated. Some managers insist on blanket indemnifications, including (without prejudice to generality) indemnifications against criminal acts and against willful misconduct. Some partnership agreements indemnify partners against bad acts unless the partners are convicted – perhaps unless they are convicted of a felony. Some indemnifications require the partnership to pay for criminal defense until conviction has been affirmed on appeal. The extent to which criminality can be indemnified is outside of the scope of this Article. Negotiations over indemnification for criminal acts can be interesting indeed and require some diligence and imagination from all parties. Before being too complacent in indemnifying against all criminal acts, consider the possibility of the partnership indemnifying a partner from criminal charges of embezzling from the partnership or perhaps sexually assaulting a partnership employee.

Two common limitations on indemnification require that a partner or manager be indemnified –

so long as this Person acts in good faith for a purpose that the Person reasonably believes to be in, or not opposed to, the best interests of the Partnership

or

no Person shall be indemnified or held harmless if and to the extent that the liability sought to be indemnified or held harmless against results from (a) any act or omission of this Person that involves willful misconduct, intentional misconduct, gross negligence or reckless disregard of duty or knowing violation of law, (b) any act or omission that constitutes a material breach of this Agreement, or (c) any transaction from which this Person derives an improper personal benefit.

Less common, a partner or manager might be indemnified so long as the partner or manager is found not to have been negligent in the performance or his duties.

The mechanisms for determining whether an act is indemnified or not can be heavily negotiated. A partnership agreement might require that indemnification payments be made until there is a nonappealable decision that the act is not indemnified. Indemnified parties may want current payments to permit them to de-

770 Consider whether it is appropriate to indemnify “agents,” such as attorneys of members.

771 This provision mixes good faith and reasonableness standards.
fend against indemnified claims. These payments may be treated as loans to the indemnified party that are repayable if the matter is later determined not to be within the scope of the indemnification.

The mechanism of indemnification can attract heated discussions when your partnership agreement is drafted. Managers may wish to receive indemnification payments on a current basis and not wait until the matter is resolved. They often will not want to wait until the grounds for indemnification have been proven in court. Partnership agreements frequently provide for indemnification payments to be advanced for current expenses, subject to a claw back if the acts are later found not to support indemnification.

Indemnification agreements often have complicated provisions concerning who selects counsel, who controls defense, and who controls settlement and compromise. Finally, some indemnification provisions require indemnification on an after-tax basis, while others do not.

107. **Contracts with Affiliates.**

*Section x.x. Contracts with Affiliates.*

(a) The Company may lend or may contribute funds or other assets to its Subsidiaries or other Persons in which it has an equity investment. These Persons may borrow funds from the Company (on reasonable commercial terms and conditions established by the Manager). This authority shall not create any right or benefit in favor of any Subsidiary or any other Person.

(b) The Company may transfer assets to joint ventures, limited liability companies, partnerships, corporations, or other business entities in which it is or thereby becomes a participant upon reasonable commercial terms and conditions and subject to the conditions consistent with this Agreement and applicable law.

(c) Except as expressly permitted by this Agreement, neither the Manager nor any of its Affiliates shall sell, transfer or convey any property to, or purchase any property from the Company, and no Affiliate of the Manager shall provide services to the Company, directly or indirectly. The immediately previous sentence is qualified by the limitation that the Manager or any of its Affiliates may sell, transfer or convey any property to, or to purchase any property from the Company, and any Affiliate of the Manager may provide services to the Company (directly or indirectly) pursuant to transactions that are determined by the Manager in good faith to be fair and reasonable and that also have received the affirmative vote or written consent of a Majority in Interest of the Members.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

[alternative: but only if the transaction is upon terms and conditions (including (without prejudice to generality) terms and conditions of compensation) substantially equivalent to those that could be obtained by the Company under bona fide arms-length agreements under comparable circumstances between the Company and reputable, financially responsible third parties.]

A partner of a partnership has a fiduciary duty of loyalty to the partnership. This duty generally can be modified in the partnership agreement. It is unresolved whether the partnership agreement can modify the implied covenant of good faith and fair dealing. It is doubtful that the partnership agreement can completely eliminate this implied covenant of good faith and fair dealing. Delaware law does not permit elimination of this covenant. Address how the partnership will deal with the potential conflict that arises from contracts with affiliates.

108. Annual Budget.

Section x.x Budgets.

(a) Annual Budget.

(i) The Manager shall cause to be prepared, at Company expense, a proposed annual budget (the “Annual Budget”) for the Company for each Fiscal Year. The Annual Budget shall be in substantially the form of Exhibit “X”.

(ii) The Manager shall deliver the proposed Annual Budget to each Member for his approval not later than thirty (30) days prior to the expiration of the last Annual Budget. The initial Annual Budget is attached as Exhibit “X”.

(iii) The Annual Budget shall include (with respect to each Fiscal Year of the Company) the annual operating budget, stated on a month-by-month basis and on an annual basis, also setting forth in comparative form the corresponding figures for the prior Fiscal Year. The Annual Budget shall include estimated expenses, cash flows, and an estimated income statement, and an estimated statement of Capital Accounts.

(iv) The Manager shall prepare the Annual Budget in accordance with the accounting methods as may be determined by the Manager and the applicable provisions of this Agreement.

(iv) “Annual Budget” includes all subsequent amendments and revisions to the Annual Budget approved by the Members.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(b) Budget Approval. These rules apply to approval of the Annual Budget:

(i) Each Member has a period of fifteen (15) Business Days after the proposed Annual Budget is submitted to notify the Manager in writing of whether the Member approves the proposed Annual Budget.

(ii) The failure of a Member to so notify the Manager in writing (within that fifteen (15) Business Day period) shall constitute the Member’s approval of the proposed Annual Budget. If the proposed Annual Budget is approved by all Members, that budget shall constitute the “Annual Budget.”

(iii) The Members and the Manager shall negotiate in good faith to seek to resolve any questions concerning the Annual Budget.

(iv) If the proposed Annual Budget is not approved by the Members prior to the commencement of the Fiscal Year to which it relates, then the approved Annual Budget of the Company for the immediately preceding Fiscal Year shall continue to be the Annual Budget for the next Fiscal Year, with these exceptions:

(1) Non-discretionary items (for example, real property taxes) for the upcoming Fiscal Year shall be included at actual cost; and

(2) All other items for the current Fiscal Year shall be proportionately adjusted to reflect changes in the consumer price index in the Los Angeles-Riverside-Orange County area, as published by the Bureau of Labor Statistics of the United States Department of Labor from the immediately preceding year to the current year.

(c) Operation Under Budget. The Manager shall conduct the business of the Company within the Annual Budget, except that the Manager may deviate from each line item in the Annual Budget by no more than five percent (5%). The immediately previous sentence is qualified by the limitation that the aggregate annual expenditures of the Company shall not exceed the aggregate amount provided for in the Annual Budget without express unanimous written approval of the Members, except as provided above in Section x.x(b).

This is another budget provision:

Section x.x Development Budget.

(a) Adoption of Approved Development Budget. The Manager has prepared and submitted to the Non-Managing Member for initial review a draft of the development budget for the Project for all categories of
costs and expenses by line item, a copy of which draft of the development budget for the Project is attached as Schedule X. By ****, the Manager shall submit to the Non-Managing Member for approval (in the Non-Managing Member’s sole and absolute discretion) a proposed final development budget for the Project. This budget shall contain such detail as the Non-Managing Member may reasonably request, but, in any event, shall contain budgets for all categories of costs and expenses to be incurred in connection with the Project. The budget shall contain (without prejudice to generality) those line items set forth on Schedule X. The Manager shall cause the Company to comply with the Approved Development Budget in connection with the Project. The Manager shall not take any action to cause a change in or a deviation from the Approved Development Budget without the approval of the Non-Managing Member.

(b) Implementation of Approved Development Budget. The Manager (subject to the availability of adequate Company funds) shall implement the Approved Development Budget and has the authority, together with the obligation and responsibility, to manage the Project in accordance the Approved Development Budget. In performing its duties under this Section x.x, the Manager has the power to act alone, and in the name and on behalf of the Company (including (without prejudice to generality) the power to execute for and on behalf of the Company any and all documents and instruments that may be necessary or desirable to carry on the business of the Company), in connection with the affairs of the Company. Subject to Section y.y, the prior approval of the Non-Managing Member shall be required to implement Major Decisions. This approval may be evidenced by the Non-Managing Member’s approval of the Approved Development Budget, to the extent it includes specific Major Decisions.

This is a third budget provision:

x.x Annual Budget.

(a) Annual Operating Budget. Attached to this Agreement as Exhibit B is the operating budget for the Property for the period commencing on the Effective Date and ending on *****. The Company has approved this budget as the initial annual operating budget. This operating budget and each operating budget for the Property for any subsequent Fiscal Year, as approved by Company, and as amended and updated, is referred to as the “Annual Operating Budget.” No later than November 15, of each Fiscal Year, the Manager shall submit to the Members (for the Company’s review and approval) a copy of the Manager’s proposed Annual Operating Budget for the Property for the next Fiscal Year. Each proposed Annual Operating Budget shall be in the form attached as
**SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS**

Exhibit B. Until the proposed Annual Operating Budget is approved by the Company, the Manager shall operate, repair, maintain and manage the Property in accordance with the then-existing Annual Operating Budget for the Property (subject to the terms of this Section x.x below).

(b) The Manager shall use reasonably diligent efforts to operate the Property in a manner to ensure to the extent reasonably possible that the actual cost of leasing, managing, operating, repairing and maintaining the Property does not exceed the cost approved in the Annual Operating Budget for the Property. The Manager shall not incur obligations or make expenditures in connection with the Property that will result in total expenditures for the Property exceeding the total amount set forth therefor in the Annual Operating Budget for the Property by more than 5% without, in each case, the prior written approval of the Members. The Manager shall not exceed any line item of the Annual Operating Budget by more than 5% without the prior written approval of the Members.

(c) Notwithstanding the provisions of Sections x.x(a) and x.x(b), in the case of any emergency that would adversely threaten the normal operations of the Property or subject the Company or the Manager to civil or criminal liability, the Manager may make the necessary expenditures. The Manager shall promptly notify the Members of these expenditures as soon as reasonably possible.

Real estate partnerships frequently provide for adoption of an annual budget and financial plan. The manager often is given broad discretion in managing the business, if he or she adheres to the budget and financial plan. Your partnership agreement may provide procedures for the preparation and approval of the annual budget. Your partnership agreement should provide a mechanism for the interim conduct of partnership operations if the budget and financial plan are not adopted on a timely basis. Consider providing that the last adopted budget shall continue to control (with an inflation escalator) until the new budget is adopted. The budget and financial plan should provide some flexibility for contingency items and unexpected increases in some cost items. A manager might be required to adhere to the budget, but authorized to make expenditures if they are within a certain percentage error of the appropriate line item in the budget – or perhaps in an emergency as necessary to protect partnership assets. A budget should provide for some contingency reserve for unforeseen expenses. It often is useful to attach an initial budget or a budget exemplar to indicate the required form of the budget.

109. **Annual Business Plan.**

*Section x.x. Annual Business Plans.*
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(a) Adoption of Annual Business Plan. Attached as Schedule X is the Annual Business Plan for calendar year 2007. Commencing with calendar year 2008, by September 30 of each year, the Manager shall prepare and shall submit to the Non-Managing Member for initial review a draft of the annual business plan for the Company for the next calendar year. By October 15 of each year, the Manager shall submit to the Non-Managing Member for approval a proposed final annual business plan for the next calendar year in substantially the same form as the form of the budget attached in Schedule X, in such detail as the Non-Managing Member may reasonably request, but, in any event, containing budgets for the Company, a market analysis, a general outlook for each investment, capital expenditures and marketing expenses. Any business plan submitted to and approved by the Non-Managing Member shall be an “Annual Business Plan.” Until the business plan for any calendar year has been approved by the Non-Managing Member, the Annual Business Plan for the preceding calendar year shall apply to the calendar year, subject to modification to (i) reflect changes that are the result of contracts that are in effect (for example, contractual increases in Ground Lease Rent paid under the Ground Lease and contractual increases in rents received under leases entered into with Third Parties) and (ii) revisions that are automatic and over which the Members have no control (for example, annual increases in real property taxes). The Manager shall not take any action to cause a substantial change in or a substantial deviation from any Annual Business Plan without the approval of the Non-Managing Member. Each Annual Business Plan shall include, as appropriate, these items:

(i) Material Activity. A brief narrative description of any material activity planned to be undertaken.

(ii) Budgets. Capital, development and operating budgets for the Property.

(iii) Income Statements. A projected annual income statement (prepared on an accrual basis) on a month-by-month basis.

(iv) Projection of Distributable Cash. A projection of the timing and amount of distributions of Distributable Cash.

(v) Sources and Uses of Funds. A schedule of total projected Distributable Cash and projected uses of monies in any reserves on a month-by-month basis (including (without prejudice to generality) a schedule of projected negative Distributable Cash, if any). This schedule shall include (without prejudice to generality) the categories of itemized revenues and expenses used for the Annual Business Plan for year ****
and such other categories as the Non-Managing Member may reasonably request.

(vi) Marketing Plan. If the Members have elected to attempt to sell any assets of the Company during the applicable year, a marketing plan indicating the assets of the Company to be made available for sale and a schedule of offering prices for these assets and indicating the sales plans (if any) for Company assets.


(viii) Capital Expenditures. A description of any proposed construction, capital, fixtures, furnishing and equipment or other personal property expenditures. This shall include (without prejudice to generality) projected dates for commencement and completion of the foregoing.

(ix) Investment Plans. Any changes in the investment plans for the Company’s cash assets.

(x) Fees. A description of the types of services to be provided for, the identity of the recipient (if known) of, and the amount and purpose of, all fees and other payments proposed or expected to be paid, for professional services and, if a fee or payment exceeds **** on an annual basis, for other services rendered to the Company by Third Parties.

(xi) Necessary Information. A detailed description of the other information, plans, maps, contracts, agreements or other matters necessary in order to inform the Non-Managing Member of all material matters relevant to the development, operation, management, and (if the Members have elected to attempt to sell any assets of the Company during the applicable year) sale of Company assets or any portion thereof.

(b) Implementation of Annual Business Plan. The Manager (subject to the availability of Company funds) shall implement the then applicable Annual Business Plan and has the authority, together with the obligation and responsibility, to manage the Company's business in accordance therewith. In performing its duties under this Section X, the Manager has the power to act alone, and in the name and on behalf of the Company in connection with the affairs of the Company consistent with the Approved Business Plan. This includes (without prejudice to generality) the power to execute for and on behalf of the Company any and all documents and instruments that may be necessary to carry on the business of the Company. The Non-Managing Member’s Consent shall be required to implement Major Decisions. This approval may be evidenced by the
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Non-Managing Members’ approval of the Annual Business Plan, to the extent it includes specific Major Decisions.

A good budget is a good starting point for a partnership. Sound business practice often requires that the partnership have a full business plan that is adopted or amended each year. The immediately previous provision is an example of a simple provision requiring annual adoption and approval of business plans.

110. Reports.

Provide for the regular reports that the manager is required to provide to partners. This often includes annual financial statements and the partnership’s annual tax returns. Clarify if the annual financial reports are required to be audited. Clarify if the annual financial reports must be prepared in accordance with Generally Accepted Accounting Principles. Some partnership agreements require interim monthly or quarterly financial reports. The partnership may be specific in information required in financial reports. This information might include balance sheet, income statement, and cash flow statement, statement of changes in shareholders’ equity, notes, and comparison of operations to plan. The annual report may be required to compare performance to the budget or to a partnership business plan. You may wish (in appropriate circumstances) to provide for the partnership to provide interim state-tax related information to partners. This required information can differ considerably from state to state. This is an example of a provision concerning reports to partners:

Section x.x Reports to Members.

(a) Monthly Reports. The Manager shall prepare and shall deliver to the Members as soon as practicable (but in no event later than fifteen (15) days after the end of each calendar month) a monthly report or operations that shall –

(i) Outline in reasonable detail in narrative form the status of implementation of all major decisions that have not been fully implemented;

(ii) Itemize in reasonable detail all revenues and expenses of the Company that arose or were paid or received during the

772 Consider consulting with local tax counsel concerning the special information concerns that may apply with respect to operations in a particular jurisdiction.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

preceding calendar month (together with an explanation for any variances from the Annual Budget and the Business Plan for that period); and

(iii) Present in reasonable detail the financial condition of the Company; and

(iv) Compare actual results of operations of the Company to the Business Plan.

(b) Quarterly Reports. The Manager shall prepare and shall deliver to the Members as soon as practicable (but in no event later than thirty (30) days after the end of each fiscal quarter), quarterly reports describing –

(i) All material agreements entered into by or on behalf of the Company during the quarter;

(ii) The progress of any construction, renovation, repair or other activities described in the Annual Budget and the Business Plan;

(iii) Any other material transactions occurring during the immediately prior quarter; and

(iv) Any other material aspects of the operations of the Company for the immediately prior quarter.

In addition, as soon as practicable (but in no event later than forty-five (45) days after the end of each fiscal quarter), the Manager shall cause to be prepared and furnished to the Members unaudited quarterly financial statements of the Company for the applicable fiscal quarter accurately reflecting the financial condition and the results of operation of the Company (all prepared in accordance with the accounting methods as may be approved by the Members and this Agreement).

(c) Annual Reports. As soon as practicable (but in no event later than sixty (60) days after the end of each Fiscal Year during the term of this Agreement), the Manager shall arrange for and furnish to the Members annual unaudited financial statements for the Fiscal Year accurately reflecting the financial condition and the results of operation of the Company, all prepared in accordance with the accounting methods as may be approved by the Members and the applicable provisions of this Agreement. This shall include (without prejudice to generality) statements and calculations of Distributable Cash, net proceeds from Capital Transactions and costs incurred by the Company in connection with the acquisition, development, construction, marketing and sale of each Property. If so directed by the Members, the annual financial statements shall be audited and certified by the Company’s accountants to be in compliance with
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Generally Accepted Accounting Principles (in which event financial statements shall be delivered to the Members no later than one hundred twenty (120) days after the end of the Fiscal Year).

(d) Information Requests. The Manager shall provide all information reasonably requested in writing by any Member related to the business and operations of the Company. This information shall include (without prejudice to generality) reports or data sent to the Company concerning its business activities or any Property.

This is another example of a provision for regular reports to members:

x.x Monthly and Quarterly Reports. By the tenth (10th) day of each calendar month, the Manager will prepare and will submit to the Members an income and expense report for the Property showing the results of operations for the immediately prior calendar month. This report will summarize all rents and other income collected for the Property and all expenses for the Property. This monthly income and expense report will separately set forth data for in columnar form both for the month being reported and for the Fiscal Year to date. All costs and expenses incurred by the Manager in connection with the preparation of any reports under this Section x.x by the Manager will be borne by the Manager. The Manager will furnish a quarterly report (prepared on a calendar quarterly basis) summarizing the financial operations of the Property (“Quarterly Financial Report”). The Quarterly Financial Report will be due to the Company on the 10th day of the calendar month immediately following the immediately prior calendar quarter and will separately report in columnar form data both for the quarter being reported and for the Fiscal Year to date (to the extent applicable). The Quarterly Financial Report will include these sections:

(a) Income Statement.
(b) Actual versus Budget Operating Statement.
(c) Actual versus Budget Operating Expenses.
(d) Actual versus Budget Capital Expenses.
(e) Accounts Receivable Aging Report.
(f) Company Balance Sheet.

111. Right to Information from Partners.

Treasury Regulations on “substantiality” require that the after-tax effects of partnership allocations be compared to the result that would be reached under
the standard of “in accordance with partners’ interests in the partnership.” A well-drafted partnership agreement might require partners to provide the partnership with the necessary personal tax and economic information and the necessary projections. (Partners, however, might resist this obligation.) The application of state tax laws may require information from partners. Consider a general provision that requires partners to provide tax-related information to the partnership. A special information provision might read something like this:

Section x.x. State and Local Tax Information. Upon reasonable request of the Partnership, any Partner shall cooperate fully with any reasonable requests for information made by the Partnership to provide information concerning the Partner, its finances, its tax items, its future financial projections, or otherwise, necessary or useful to the Partnership in determining the federal, state, or local tax obligations of the Partnership or otherwise necessary or desirable to confer benefits or concessions on the Partnership from any federal, state, or local taxing jurisdiction. This cooperation shall be undertaken at the expense of the Partner.

112. Partner’s Right to Partnership Information.

Some partnership agreements will seek to restrict a partner’s right to information from the partnership. Be careful in limiting this right. See, for example, Delaware Limited Liability Act § 18-305 (“§ 18-305. Access to and confidentiality of information; records. (a) Each member of a limited liability company has the right, subject to such reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense) as may be set forth in a limited liability company agreement or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the limited liability company from time to time upon reasonable demand for any purpose reasonably related to the member's interest as a member of the limited liability company: (1) True and full information regarding the status of the business and financial condition of the limited liability company; (2) Promptly after becoming available, a copy of the limited liability company's federal, state and local income tax returns for each year; (3) A current list of the name and last known business, residence or mailing address of each member and manager; (4) A copy of any written limited liability company agreement and certificate of formation and all amendments thereto, together with executed copies of any written powers of attorney pursuant to which the limited liability company agreement and any certificate and all amendments thereto have been executed; (5) True and full information regarding the amount of (footnote continued on the next page)
cash and a description and statement of the agreed value of any other property or services contributed by each member and which each member has agreed to contribute in the future, and the date on which each became a member; and (6) Other information regarding the affairs of the limited liability company as is just and reasonable. (b) Each manager shall have the right to examine all of the information described in subsection (a) of this section for a purpose reasonably related to the position of manager. (c) The manager of a limited liability company shall have the right to keep confidential from the members, for such period of time as the manager deems reasonable, any information which the manager reasonably believes to be in the nature of trade secrets or other information the disclosure of which the manager in good faith believes is not in the best interest of the limited liability company or could damage the limited liability company or its business or which the limited liability company is required by law or by agreement with a 3rd party to keep confidential. (d) A limited liability company may maintain its records in other than a written form if such form is capable of conversion into written form within a reasonable time. (e) Any demand by a member under this section shall be in writing and shall state the purpose of such demand. (f) Any action to enforce any right arising under this section shall be brought in the Court of Chancery. If the limited liability company refuses to permit a member to obtain or a manager to examine the information described in subsection (a)(3) of this section or does not reply to the demand that has been made within 5 business days after the demand has been made, the demanding member or manager may apply to the Court of Chancery for an order to compel such disclosure. The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking such information is entitled to the information sought. The Court of Chancery may summarily order the limited liability company to permit the demanding member to obtain or manager to examine the information described in subsection (a)(3) of this section and to make copies or abstracts therefrom, or the Court of Chancery may summarily order the limited liability company to furnish to the demanding member or manager the information described in subsection (a)(3) of this section on the condition that the demanding member or manager first pay to the limited liability company the reasonable cost of obtaining and furnishing such information and on such other conditions as the Court of Chancery deems appropriate. When a demanding member seeks to obtain or a manager seeks to examine the information described in subsection (a)(3) of this section, the demanding member or manager shall first establish (1) that the demanding member or manager has complied with the provisions of this section respecting the form and manner of making demand for obtaining or examining of such information, and (2) that the information the demanding member or manager seeks is reasonably related to the member's interest as a member or the manager's position.

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

situations in which partners may need information from the partnership in order to
comply with state or local tax laws or to receive benefits under state or local tax
laws. This information may go beyond the information that is typically included
in federal and state tax returns of the partnership and K-1 information normally
provided to partners. This information, for example, might include information
necessary to determine state apportionment factors in determining franchise tax or
corporate income tax. A special information provision might read something like this:

Section x.x. State and Local Tax Information. Upon reasonable request
of any Partner, the Partnership shall cooperate fully with any reasonable
requests for information made by the requesting Partner to provide infor-
mation concerning the Partnership, its business, or its sales, compensa-
tion, or assets. The immediately previous sentence is subject to the re-
quirement that the information is likely to be necessary or useful to the re-
questing Partner in determining the federal, state, or local tax obliga-
tions of the requesting Partner or otherwise necessary or desirable to confer
benefits or concessions on the Partner from any federal, state, or local
taxing jurisdiction. This cooperation shall be undertaken at the expense of
the requesting Partner.

The partnership might consider seeking to limit access to K-1 information,
particularly partners’ social security numbers.

__________________________
as a manager, as the case may be. The Court of Chancery may, in its discretion,
 prescribe any limitations or conditions with reference to the obtaining or examin-
ing of information, or award such other or further relief as the Court of Chancery
may deem just and proper. The Court of Chancery may order books, documents
and records, pertinent extracts therefrom, or duly authenticated copies thereof,
to be brought within the State of Delaware and kept in the State of Delaware upon
such terms and conditions as the order may prescribe. (g) The rights of a member
or manager to obtain information as provided in this section may be restricted in
an original limited liability company agreement or in any subsequent amendment
approved or adopted by all of the members and in compliance with any applicable
requirements of the limited liability company agreement. The provisions of this
subsection shall not be construed to limit the ability to impose restrictions on the
rights of a member or manager to obtain information by any other means permit-
ted under this section.”).
113. **Books and Records.**

Your partnership agreement should clarify what books and records should be maintained, where they will be maintained, and who has responsibility for maintaining them. Define member rights to access books and records and to photocopy portions of the books and records. Consult the applicable partnership statute in establishing these rights. Your partnership agreement may permit the manager to keep certain information confidential from the partners. The provision concerning books and records needs to be rethought individually for every partnership.

A simple provision might provide:

Section x.1. **Books and Records.** The Managers shall maintain (or cause to be maintained) all of the books and records of the Company. The Company shall maintain all of these materials at its principal office. Copies shall be available at all times during normal business hours for inspection and copying upon reasonable Notice by any Member or its authorized representatives (at the Member’s or the representatives’ own expense) for any purpose reasonably related to the Member’s Interest in the Company. These books and records shall include these items:

(a) True and full information regarding the status of the business and financial condition of the Company;

(b) A current list of the full name and last known business, residence or mailing address of each Member;

(c) Promptly after becoming available, a copy of the Company’s federal, state and local income tax returns (if any) for each Fiscal Year;

(d) A copy of this Agreement and any and all amendments thereto, together with executed copies of any powers of attorney under which this Agreement or any amendments thereto have been executed;

(e) A copy of the Certificate of Formation and all amendments thereto for the Company;

(f) A current list detailing the amount of cash and statement of the agreed value of any other property contributed by each Member to the capital of the Company and that each Member has agreed to contribute in the future; and

(g) The date upon which each Member became a Member of the Company.
Section x.2. Accounting. The books of account of the Company shall be kept (and the financial position and the results of its operations shall be recorded) in accordance with the method of accounting as determined by the Managers. The books and records of the Company shall reflect all of the Company transactions and shall be appropriate and adequate for the Company’s business.

Section x.3. Reports. The Managers shall cause to be filed all documents and reports required to be filed with any governmental agency. The Managers shall cause to be prepared and duly and timely filed (at the Company’s expense) all tax returns and reports required to be filed by the Company. The Managers shall send or cause to be sent to each Member (within ninety (90) days after the end of each Fiscal Year) such information relating to the Company that the Managers determine is necessary for the Members to complete their federal, state and local income tax returns that include the Fiscal Year.

Another simple provision might provide:

Section x.1. Books and Records. Proper and complete records and books of account shall be kept by the General Partner in which shall be entered fully and accurately all transactions and other matters relative to the Partnership’s business as are usually entered into records and books of account maintained by businesses of a similar character. The Partnership books and records shall be kept on the cash method of accounting. All methods of accounting, elections and the treatment of particular transactions shall be as consistent as reasonably possible with the methods of accounting, elections and treatments employed for Federal income tax purposes. The books and records shall be maintained at the principal office of the Partnership. The books and records of the Partnership shall be open to the inspection and examination of the Partners or their duly authorized representatives for a proper purpose during reasonable business hours and at the sole cost and expense of the inspecting or examining Partner.

Section x.2. Quarterly Reports. The General Partner shall furnish or cause to be furnished to each Limited Partner this information with respect to each quarter of each Fiscal Year:

(a) A balance sheet of the Partnership as of the end of the quarter and statements of operations and cash flows of the Partnership for the quarter;
(b) A statement of the Partners’ Capital Account balances;
(c) A report on major Partnership transactions during the quarter; and
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(d) A reconciliation of the budget of the Partnership to actual results during the quarter.

Section x.3. Annual Reports. Within 90 days after the end of each Fiscal Year of the Partnership, the General Partner shall cause the Partnership to send to each Person who was a Limited Partner at any time during the Fiscal Year:

(a) Financial statements of the Partnership audited by the Partnership accountants and certified by them to be prepared in accordance with Generally Acceptable Accounting Principles;

(b) A statement of the Partners’ Capital Account balances;

(c) A narrative report on major Partnership transactions during the Fiscal Year;

(d) A reconciliation of the budget of the Partnership to actual results during the Fiscal Year.

This provision might be useful for some partnerships:

Section x.x. Maintenance of Records.

(a) Accounts and Document Filing System. The Manager shall maintain and develop (or cause the Property Manager and Developer to maintain and develop) on a current basis a uniform system of accounts and document filing system with respect to the Company. All records shall be maintained at the principal office of the Company.

(b) Property Files. The Manager shall maintain (or cause the Property Manager and Developer to maintain) files related to the Property in a good and orderly fashion (all of the files being the sole property of the Company). The files shall contain (without prejudice to generality) the following (to the extent that these items are delivered to (or otherwise come within the possession of) the Company, the Manager, the Property Manager, the Developer, or the Managing Member):

(i) Occupancy Files. Occupancy files (including (without prejudice to generality) executed leases or residency agreements and amendments, correspondence, and current rent rolls).

(ii) Maintenance Files. Maintenance and repair files.

(iii) Project Construction Files. Files related to the construction, development and progress of the Project, including (without prejudice to generality) the following: construction files, competitive bid records (including (without prejudice to generality) site plans, construction drawings, as-built drawings, plans, construction specifications, capi-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tal improvements schedules and information, construction contracts, architects agreements, engineering contracts and subcontracts).

(iv) Accounting Files. Accounting books and records and supporting documentation.

(v) Operation Files. Operation files (including HVAC maintenance schedules, warranties, and operation manuals).

(vi) Service Contracts. Service contracts, including, but not limited to cleaning, maintenance, landscaping, trash removal, etc.

(vii) Permits. Permits, licenses, certificates of occupancy, approvals, decisions and certifications from any and all governmental authorities.

(viii) Insurance. Copies of insurance policies or certificates.


(x) Additional Information. Other Property information as any Member reasonably requests.

(c) Audit. Any Member who is not the Manager may audit (at its own expense) the books, records and internal systems and procedures of the Company (as may be necessary or appropriate to ascertain the appropriateness and reasonableness of the allocations and internal audit procedures of the Company). Any audit shall take place during normal business hours of the Company. If a Member requires more than two (2) audits in any calendar year, the Member shall reimburse the Manager for the actual and reasonable costs incurred by the Manager in cooperating with the additional audits. The immediately previous sentence is qualified by the requirement that no reimbursement shall be required if the results of any audit conducted in the calendar year indicate a significant and material variance from reports and summaries furnished by the Manager to the Member.

(d) The Manager shall keep (or cause the Property Manager and Developer to keep) at the principal office of the Company a current list of the full name and last known business or residence address of each Member, a copy of the Certificate and all certificates of amendment to any of them, together with executed copies of any powers of attorney under which any of the certificates or any amendments have been executed, copies of the Company’s federal, state and local income tax or information returns and reports (if any) for the six (6) most recent taxable years, copies of this Agreement and any amendments thereto, copies of any and all financial
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Statements of the Company for the six (6) most recent Fiscal Years, and the books and records of the Company as they relate to the internal affairs of the Company for at least the current and past six (6) Fiscal Years, if any. This shall include (without prejudice to generality) calculations of Capital Accounts and returns and (for purposes of satisfying the request of an appraiser) a true copy of business records relevant to the amount, cost and value of all property owned, claimed, possessed or controlled by the Company. Each Member has the right to inspect and to copy during normal business hours any of the Company’s books, records, agreements and other documents.774

774 The Delaware limited liability company laws, for example, give each member the right to access to listed confidential information of the company (subject to reasonable standards):

§ 18-305. Access to and confidentiality of information; records.

(a) Each member of a limited liability company has the right, subject to such reasonable standards (including standards governing what information and documents are to be furnished at what time and location and at whose expense) as may be set forth in a limited liability company agreement or otherwise established by the manager or, if there is no manager, then by the members, to obtain from the limited liability company from time to time upon reasonable demand for any purpose reasonably related to the member’s interest as a member of the limited liability company:

(1) True and full information regarding the status of the business and financial condition of the limited liability company;

(2) Promptly after becoming available, a copy of the limited liability company’s federal, state and local income tax returns for each year;

(3) A current list of the name and last known business, residence or mailing address of each member and manager;

(4) A copy of any written limited liability company agreement and certificate of formation and all amendments thereto, together with executed copies of any written powers of attorney pursuant to which the limited liability company agreement and any certificate and all amendments thereto have been executed;

(5) True and full information regarding the amount of cash and a description and statement of the agreed value of any other property or services contributed by each member and which each member has agreed to contribute in the future, and the date on which each became a member; and

(footnote continued on the next page)
(6) Other information regarding the affairs of the limited liability company as is just and reasonable.

(b) Each manager shall have the right to examine all of the information described in subsection (a) of this section for a purpose reasonably related to the position of manager.

(c) The manager of a limited liability company shall have the right to keep confidential from the members, for such period of time as the manager deems reasonable, any information which the manager reasonably believes to be in the nature of trade secrets or other information the disclosure of which the manager in good faith believes is not in the best interest of the limited liability company or could damage the limited liability company or its business or which the limited liability company is required by law or by agreement with a 3rd party to keep confidential.

(d) A limited liability company may maintain its records in other than a written form if such form is capable of conversion into written form within a reasonable time.

(e) Any demand by a member under this section shall be in writing and shall state the purpose of such demand.

(f) Any action to enforce any right arising under this section shall be brought in the Court of Chancery. If the limited liability company refuses to permit a member to obtain or a manager to examine the information described in subsection (a)(3) of this section or does not reply to the demand that has been made within 5 business days after the demand has been made, the demanding member or manager may apply to the Court of Chancery for an order to compel such disclosure. The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking such information is entitled to the information sought. The Court of Chancery may summarily order the limited liability company to permit the demanding member to obtain or manager to examine the information described in subsection (a)(3) of this section and to make copies or abstracts therefrom, or the Court of Chancery may summarily order the limited liability company to furnish to the demanding member or manager the information described in subsection (a)(3) of this section on the condition that the demanding member or manager first pay to the limited liability company the reasonable cost of obtaining and furnishing such information and on such other conditions as the Court of Chancery deems appropriate. When a demanding member seeks to obtain or a manager seeks to examine the information described in subsection (a)(3) of this section, the demanding member or manager shall first establish (1) that the demanding member or manager has complied with the provisions of this sec-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

If the partnership has different series of assets, there may be special record-keeping requirements. Delaware law requires the maintenance of “separate and distinct records” for each series and its assets and separate accounting for each series in order for each series to be insulated from the liabilities of other series. 775

Consider providing for preservation of the books and records of the partnership after its dissolution, who will have continuing custody after dissolution, and who will bear the storage costs.

114. Voting and Amendments.

Clarify what votes are required for particular acts and what votes are required to amend your partnership agreement. Decisions often are broken into “Major Decisions” and “Minor Decisions,” with a greater vote or unanimous vote required for Major Decisions. This is a typical example of some Major Decisions that might require unanimous vote.

delaware limited liability act § 18-305.

775 delaware limited liability act § 18-215(b).
Section x.x. Major Decisions. Unless the act is expressly permitted by this Agreement or is approved by Unanimous Consent and (to the extent required) approved by any lender to the Company, neither the Manager nor any other Member has the authority to do any of these acts with respect to the assets or business of the Company (“Major Decisions”):

(a) To cause or to permit the Company to obtain or to modify any loan that would result in or increase the liability of any Member or its Affiliate under any guaranty or indemnity.

(b) To invest in any subsidiary Entity to which the Company shall transfer its assets.

(c) Voluntarily to cause or to permit (directly or indirectly) the Company to take any action that would constitute an act of Bankruptcy.

(d) To cause or to permit the Company to acquire any asset not within the scope of the Company’s primary purpose or otherwise not related to a Project.

(e) To cause or to permit the Company or any Member to take any act in contravention of this Agreement (including (without prejudice to generality) the acceptance of additional Capital Contributions or loans from Members or permitting the Transfer of any interest in the Company not expressly provided for in this Agreement).

(f) To change the business or purposes of the Company.

(g) To sell, to exchange or otherwise to dispose of all or substantially all of the Project or all or substantially all of the assets of the Company and to determine the terms of any sale, exchange or other disposition, other than dispositions and replacements of real property or personal property in the ordinary course of business.

(h) To acquire any property by the Company (including (without prejudice to generality) the terms and conditions for any acquisition) (except for the acquisition of personal property having a fair market value of ***** or less with respect to any single transaction (except as specifically approved in the Business Plan)).

(i) To admit any new Member into the Company.

(j) To cause the Company to enter into any merger, consolidation, liquidation, bankruptcy proceeding, dissolution, company, joint venture, limited liability company or other material corporate transaction. This includes (without prejudice to generality) the entry into by the Company of any composition with creditors and/or the filing of any proceeding under the United States Bankruptcy Code.
(k) To cause the Company to extend credit or to cause the Company to make any loans or become a surety, guarantor, endorser or accommodation endorser for any person or entity.

(l) To finance or to refinance all or any portion of any Project, and to cause the Company to borrow funds for working capital or other purposes, to determine the terms of any financing, refinancing, lease or borrowing, and to amend or modify any loan or lease documents.

(m) To approve all annual Business Plans and all amendments to those plans.

(n) To initiate any litigation, arbitration or other proceeding on behalf of the Company, or to settle any litigation, arbitration or other proceeding that would require any expenditure by the Company, or to decide not to initiate collection proceedings with respect to any receivable or to confess any judgment against the Company.

(o) To select or to remove the architect or the general contractor.

(p) To distribute to the Members any asset of the Company or to accept as a capital contribution any asset. This limitation does not apply to a distribution or contribution of money.

(q) To remove or to modify the authority of the Tax Matters Member.

(r) To select the Manager, to remove the Manager, or to change the Manager’s compensation or duties.

(s) To determine the types, levels, deductibles, and conditions of insurance (including (without prejudice to generality) ratings of insurers [such as their ratings by Standard & Poor’s and by Alfred M. Best Company, Inc.;]) to be obtained by the Company and the identity of the insurers, and the issuance of certificates of insurance to the Company.

(t) To appoint, to determine the terms of employment, or to change the terms of employment of any key employee or agent of the Company.

(u) To cause the Company to execute or to furnish guarantees.

(v) To approve any material contract or agreement.

(w) To cause the Company to assume any contract, agreement or other obligation of any Person.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(x) To approve any contract or agreement with any Member or any Affiliate or other arrangement for procuring property or services from any Member or any Affiliate.

(y) To retain legal counsel or any independent tax or accounting firms; and

(z) To appoint or to remove any officer of the Company.

115. Meetings.

Set forth provisions relating to notice of the time, place or purpose of any meeting at which any matter is to be voted on by any member, waiver of any notice, action by consent without a meeting, the establishment of a record date, quorum requirements, voting in person or by proxy, attending by telephone, or any other matter with respect to the exercise of any such right to vote. This is a simple short-form provision concerning member or partner meetings:

Section x.x. Meetings of Members; Written Consent. No annual or regular meetings of the Members shall be required, but if held, shall be held at such times and places within or outside the State of Delaware as the Management Committee shall fix. In addition, meetings of the Members may be called upon the written demand of any Member for the purpose of addressing any matters on which the Members may vote. If meetings of the Members are held, they shall be noticed, held and conducted pursuant to any applicable requirements of the Delaware Act. Members may participate in any meeting through the use of conference telephones or similar communications equipment as long as all Members participating can hear one another. A Member so participating is treated as present in person at the meeting. Except as otherwise expressly provided in this Agreement, any action with respect to the Company by the Members at any meeting requires the affirmative vote of Members holding more than fifty percent (50%) of then outstanding Units. All Members may vote, even if the Member is interested in the particular issue or transaction being voted upon. Any action that may be taken by the Members at a meeting also may be taken without a meeting, if a consent in writing setting forth the action so taken is signed by Members having not less than the minimum votes that would be necessary to authorize that action at a meeting of the Members duly called and noticed, assuming all Members are present and vote.

This is another example of a provision governing meetings of partners:
Section x.x. Meetings of the Members.

(a) Meetings of the Members may be called by the Manager and shall be called upon the receipt by the Manager of a written request by a Majority in Interest of the Non-Managers. The request shall state the nature of the business to be transacted. Notice of any meeting shall be given to all Members not less than seven (7) days nor more than thirty (30) days prior to the date of the meeting. Members may vote in person or by proxy at the meeting. Whenever the vote or Consent of the Members is permitted or required under this Agreement, the vote or Consent may be given at a meeting of the Members or may be given in accordance with the procedure prescribed in Section y.y of this Agreement. Except as otherwise expressly provided in this Agreement, the Consent of the Non-Managers (including Non-Manager Interests held by the Manager) shall control.

(b) Any action required or permitted to be taken at a meeting of the Members may be taken without a meeting if a written consent setting forth the action so taken is signed by a majority of the Percentage Interests of the Members (or such other percentage as is expressly required by this Agreement). The consent may be in one (1) instrument or in several instruments, and has the same force and effect as a vote of a majority of the Percentage Interests of the Members (or such other percentage as is expressly required by this Agreement). The consent shall be filed with the Manager. An action so taken shall be treated as an action taken at a meeting held on the effective date so certified.

(c) Each Non-Manager may authorize any Person or Persons to act for him by proxy on all matters in which a Non-Manager is entitled to participate (including without prejudice to generality) waiving notice of any meeting, or voting or participating at a meeting). Every proxy must be signed by the Non-Manager or his attorney-in-fact. No proxy shall be valid after the expiration of one (1) year from the date thereof unless otherwise provided in the proxy. Every proxy shall be revocable at the sole and absolute discretion of the Non-Manager executing it. Any revocation shall be effective upon the Company’s receipt of written notice of the revocation from the Non-Manager executing the proxy.

(d) Each meeting of the Members shall be conducted by the Manager or such other Person as the Manager may appoint pursuant to the rules for the conduct of the meeting as the Manager or such other Person deems appropriate (in its sole and absolute discretion).
116. Written Consent.

Your partnership agreement may provide for the adoption of partner resolutions by written consent of the partners.

Section x.x. Written Consent. Any action that may be taken by the Members at a meeting may be taken without a meeting, if a consent in writing setting forth the action so taken is signed by the Members having not less than the minimum votes that would be necessary to authorize that action at a meeting of the Members duly called and noticed, assuming all Members are present and vote.

117. Legend and Investment Representations.

Partnership agreements often contain investment representations that address the requirements of Regulation D or other applicable securities exemptions. Counsel should consider securities issues in connection with the formation or issuance of equity interests in any partnership. The issuance of an interest in a limited partnership or limited liability company often is the issuance of a security. This issuance should be supervised by competent securities counsel in order to ensure that the interest either is registered or is issued under appropriate state and federal law exemptions. Violating securities laws in issuing partnership interests or in transferring partnership interests is seriously discouraged. “Security” under Section 2(1) of the Securities Act of 1933 includes investment contracts. This includes an investment in a common enterprise with the expectation of profit based primarily on the efforts of others. Partnership interests commonly are issued under the private offering transaction exemption of section 4(2) of the ‘33 Act and the exemption under section 3(b) of the Securities Act of 1933 and the safe harbors provided under Securities Act of 1933. Rule 506 under Regulation D is especially important in many partnership offerings. This legend should appear on the cover page of any offering document when partnership interests are issued under a securities exemption under Section 4(2) of the Securities Act of 1933 or under Regulation D:

THESE SECURITIES ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED UNDER THE SECURITIES ACT

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

OF 1933, AS AMENDED, AND THE APPLICABLE STATE SECURITIES LAWS, PURSUANT TO REGISTRATION OR EXEMPTION THEREFROM. INVESTORS SHOULD BE AWARE THAT THEY WILL BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

Specific legends may be required by specific state law. Most state securities laws require the inclusion of certain legends on the documents presented to prospective investors of an exempt offering of securities.

This is a typical set of investment representations by investors.

Section x.1 Investment Representations. Each Member makes these investment representations in connection with its investment in the Company:

(a) Preexisting Relationship or Experience. The Member has a preexisting personal or business relationship with the Company, the Manager or one or more of the Company’s officers or control persons or by reason of the Member’s business or financial experience, or by reason of the business or financial experience of the Member’s financial advisor who is unaffiliated with and who is not compensated (directly or indirectly) by the Company or any Affiliate or selling agent of the Company, the Member is capable of evaluating the risks and merits of an investment in the Company and of protecting the Member’s own interests in connection with the investment. The Member is an “accredited investor” as that term is defined in Rule 501(a) of Regulation D under the Securities Act.

(b) Sophistication. The Member (i) is sophisticated in real estate transactions and real estate investments; (ii) is able, either directly or through its agents and representatives, to evaluate all of the information and due diligence documents regarding the Company and its business and assets that have been presented to it and to evaluate the merits and risks of an investment in the Company and its business and assets; (iii) has carefully considered the suitability of an investment in the Company for its particular financial and tax situation and has determined that the Units are a suitable investment for it; and (iv) is able to bear the financial risk of loss presented by an investment in the Company (which includes the risk of loss of the Member’s entire investment), particularly in light of the risks that would be disclosed by a careful due diligence review and the fact that the performance of the Company and its business and assets is subject to unpredictable real estate values and governmental and other risks of subdivision and development. The Member has been advised to consult with its own attorneys and other financial advisors concerning the
legal and tax matters inherent in an investment in the Company and has done so, to the extent it has considered necessary.

(c) Independent Investigation. The Member acknowledges that (i) it and its professional advisors have been afforded the opportunity to review all of the information concerning the business and assets of the Company which is currently in the possession of the Manager, that all such materials have been provided for its and their convenience and that if it or they have declined to review any materials, it or they have done so at the Member’s peril; (ii) it has been given access to all information concerning the Company and its business and assets which it has requested, it has conducted an independent investigation of the Company, its business, and its assets, and the risks and benefits of making an investment in the Company (or has declined to do so at its peril), it has been given the opportunity to ask questions about the Company and its business and assets, and all questions have been answered satisfactorily; (iii) neither the Manager nor any Affiliate thereof has made any representations, warranties or recommendations concerning (A) the Company, its business, or its assets, (B) the merits or risks of investing in the Company, (C) the tax or economic consequences of investing in the Company, (D) the nature or extent of profits that may be derived from an investment in the Company or (E) the extent or timing of cash distributions that may be received in respect of an investment in the Company; and (iv) it is not relying upon any statements, analysis or investment advice of the Manager or its Affiliates in connection with its decision to enter into this Agreement or to make its investment in the Company.

(d) Further Acknowledgments. The Member further acknowledges that

(i) Any or all of the Company’s activities may be modified, abandoned or terminated at any time.

(ii) If the Member elects not to review the information, agreements and diligence materials relating to the Company or the business or assets of the Company and/or conduct an independent examination with respect to the business and assets, the Member is foregoing an opportunity to evaluate all of the risks inherent in the Member’s investment. The Member has elected to do so at the Member’s peril.

(iii) An investment in the Company is a speculative investment. This investment involves a substantial degree of risk. The performance of the Company, Company’s business and the Company’s assets will be subject to unpredictable real estate values, changes in the financial
and credit markets and governmental, and other risks of subdivision and development.

(iv) Transfers of Units are not permitted (except in limited circumstances expressly permitted in this Agreement) and an investment in the Company is a long-term investment without liquidity.

(v) The Member’s tax liability on the taxable income and gain allocated to the Member under this Agreement for any year may exceed the cash Distributions from the Company to the Member for the year, and the Member may have to look to sources other than Distributions from the Company to pay any tax liability or to make distributions or loans to the Members constituent partners, members or shareholders to enable them to pay their taxes. and

(vi) In light of the many factors that influence the real estate market and the performance of the business and assets of the Company, the Member is assuming the entire risk of loss on the Members investment in the business and assets of the Company, and does not have any claim against the Company or any of the other Members with respect to this loss except as may be expressly set forth in this Agreement.

(e) No Representative or Agent. No other Member is acting as its representative or agent or in any other capacity, fiduciary or otherwise, on its behalf in connection with the Company, its business or its assets and/or any other matter referred to in this Agreement.

(f) Investment Intent. The Member is acquiring its Units for investment purposes and for the Member’s own account only and not with a view to, or for sale in connection with, any distribution of all or any part of its Units. Except for the partners, members or shareholders of the Member, no other Person will have any direct or indirect beneficial interest in, or right to, its Units.

(g) Purpose of Entity. If the Member is a corporation, partnership, limited liability company, trust or other entity, it was not organized for the specific purpose of acquiring its Units. The Member is not composed of more than fifty (50) persons for purposes of Section 3(c)(1) of the Investment Company Act of 1940, as amended.

(h) Location of Member. The Member (if a natural Person) is a resident of the State of Maine, or if the Member is an Entity, its principal place of business is located in the State of Maine.

(i) No Advertising. The Member has not seen, received or been solicited by any leaflet, public promotional meeting, newspaper or magazine Article or advertisement, radio or television advertisement or any
other form of advertising or general solicitation with respect to the purchase of its Units.

(j) Units Are Restricted Security. The Member understands that its Units are a “restricted security” under the Securities Act in that its Units will be acquired from the Company in a transaction not involving a public offering, that its Units may be resold without registration under the Securities Act only in certain limited circumstances and that otherwise its Units must be held indefinitely.

(k) No Registration of Units. The Member acknowledges that its Units have not been registered under the Securities Act or qualified under any state securities law in reliance, in part, upon its representations, warranties and agreements in this Agreement. The Member understands that the Company and the other Members are relying on the accuracy of the representations set forth in this Section x.x in entering into this Agreement without requiring that the interests in the Company be registered under federal or state securities laws.

(l) Anti-Money Laundering and Anti-Terrorism Measures. The Member may be subject to certain anti-money laundering and customer identification regulations promulgated pursuant to the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 and any other applicable anti-money laundering law and regulation. The Member has taken such steps as it deems necessary or desirable to comply with any anti-money laundering regulations applicable to it, which may include obtaining additional information with respect to the identity of investors and their beneficial owners, if any, and disclosing such information to such parties or to law enforcement or regulatory authorities.

118. Certification of Interests.

Interests in a partnership may be certificated. For example, a lender may insist on certification of partnership interests. This is a typical provision concerning certification of partnership interests:

Section x.x. Membership Interest Certificates. The Company may issue (but shall not be required to) certificates evidencing Membership Interests (“Membership Interest Certificates”) to Members of the Company. Once Membership Interest Certificates have been issued, they shall continue to be issued as necessary to reflect current Membership Interests held by the Members. Membership Interest Certificates shall be in such form as may be approved by the Management Committee, shall be manually signed by
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

an officer of the Company designated by the Management Committee, and shall bear conspicuous legends evidencing the restrictions on Transfer and the purchase rights of the Company and the Members set forth in this Agreement. All issuances, reissuances and other transactions in Membership Interests involving Members shall be recorded in a permanent ledger as part of the books and records of the Company. No Transfer of a Membership Interest shall be effective until the Transfer of the Membership Interest is registered upon the books and records of the Company maintained for that purpose. Upon the issuance of Membership Interest Certificates, all issued and outstanding Membership Interests shall be treated as “securities” (within the meaning of Sections 8-102(15) and 8-103 of the Delaware Uniform Commercial Code). The designation of the Membership Interests as “securities” under this provision shall be solely for the purposes of the Delaware Uniform Commercial Code, and shall not indicate that they are “securities” for any other purpose or under any other provision of law.

This is another provision providing for certificated interests:

Section x.x. Certificates Evidencing Units. The Company may issue to its Members certificates representing the Units held by the Member. These certificates shall be signed on behalf of the Company by its officers either manually or by facsimile. If a certificate is worn out or lost, the certificate may be renewed on production of the worn out certificate or on satisfactory proof of its loss, together with such indemnity as may be required by the Board. Each certificate for Units shall be imprinted with a legend substantially in the following form:

THE UNITS REPRESENTED BY THIS CERTIFICATE WERE ORIGINALLY ISSUED AS OF ******, HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE “ACT”), AND MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF AN EFFECTIVE REGISTRATION STATEMENT UNDER THE ACT OR AN EXEMPTION FROM REGISTRATION THEREUNDER. THE TRANSFER OF THE UNITS REPRESENTED BY THIS CERTIFICATE IS SUBJECT TO THE CONDITIONS SPECIFIED IN A LIMITED LIABILITY COMPANY AGREEMENT BY AND AMONG THE MEMBERS THAT GOVERNS THE ISSUER (THE “COMPANY”). A COPY OF SUCH CONDITIONS SHALL BE FURNISHED BY THE COMPANY TO THE HOLDER HEREOF UPON WRITTEN REQUEST AND WITHOUT CHARGE.
119. Confidentiality.

Section x.x. Confidentiality. The Partners agree to maintain the confidentiality of the financial terms and conditions of this Agreement and to maintain the confidentiality of (i) any financial information provided by one (1) party to the other, and (ii) all information contained in any plans, specifications, manuals, forms, contracts, books, records, computer discs and similar materials containing information, invoices and other documents received or maintained by the Partnership under this Agreement, other than information that is available from public sources. The Partners may disclose any of the information to their respective agents, directors, officers, employees, advisors, attorneys, affiliates or representatives who require the information for the purpose of performing or assisting in the performance of their obligations or services under this Agreement, and to investors or lenders or proposed investors or lenders. The immediately previous sentence is qualified by the requirement that in all such cases the parties shall be informed of the confidential nature of the information. The Partners also may disclose any such information –

(a) To the extent required by law, regulation (including Securities and Exchange Commission regulations) or court order. The immediately previous sentence is qualified by the requirement that the party first (to the extent reasonably practicable) has advised the other parties of the requirement to disclose the information and has afforded the other parties an opportunity to dispute the requirement and seek relief therefrom by legal process.

(b) In connection with any suit, action, arbitration or other proceedings between the parties hereto or their respective Affiliates.

(c) To the extent required in connection with the preparation or filing of any income tax returns or other filings required by any applicable law. Any press releases or other public announcements concerning the Partnership or the arrangement between the Partners shall be approved by Partner Consent.

Partnership agreements frequently provide confidentiality agreements among partners. Partnership agreements sometimes contain long-form confidentiality agreements.

This is another example of a typical short-form confidentiality agreement for a partnership:

Section x.x. Confidentiality. All books, records, financial statements, tax returns, budgets, business plans and projections of the Company, all other information concerning the business, affairs and properties of the
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Company and all of the terms and provisions of this Agreement (including (without prejudice to generality) amounts pledged and invested by each Member under this Agreement) shall be held in confidence by each Member, the Managers and their respective Affiliates, subject to any obligation to comply with (a) any applicable law, (b) any rule or regulation of any legal authority or securities exchange or (c) any subpoena or other legal process to make information available to the Persons entitled thereto. The immediately previous sentence is qualified by the requirement that (prior to making any disclosure) the Member shall notify the Managers of any proposed disclosure sufficiently in advance to permit the Managers to seek to limit or quash the disclosure. This confidentiality shall be maintained until the time (if any) as any the confidential information either is, or becomes, published or a matter of public knowledge. Notwithstanding the foregoing, any Member may disclose the foregoing information to its tax, legal and investment advisors, lenders and accountants and other persons similarly situated. The immediately previous sentence is qualified by the requirement that the Member notifies these Persons of the foregoing confidentiality requirements and these Persons agree to abide by the confidentiality requirements. Each Member agrees that damages are inadequate remedy if here is a breach of this Section x.x and that the Company may enforce this provision through specific performance, to which each Member consents without the obligation of the Company to post a bond or other security. This Section x.x will survive the termination of this Agreement or the termination of any Member’s Interest in the Company.

120. Non-Competition.

Partnership agreements often contain extensive covenants not to compete under which partners agree not to compete with the business of the partnership. This often includes minority investment in businesses that are competitive with the business of the partnership. These covenants sometimes extend beyond the termination of a partner’s interest in the partnership. The enforceability of non-competition covenants is a matter of state law that should be considered on a case-by-case basis. Alternatively, your partnership agreement may specifically permit partners investing in and undertaking activities competitive with the business of the partnership. This is a typical provision:

Section x.x. Noncompetition.

(a) No Member, Manager or Affiliate, directly or indirectly, shall compete with the business of the Company at any time prior to the earlier of (i) the second anniversary of the date when the Member’s Membership Interest is terminated or the Manager ceases to act in the capacity
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

on behalf of the Company or (ii) the date when the Company or its successors in interest cease to engage in the Company’s business. During this period, the Member, Manager or Affiliate shall not:

(i) Engage in any financing for, any Person, business, activity or project (whether as director, officer, shareholder, owner, employee, agent, representative, security holder, member, consultant or otherwise) that is directly or indirectly competitive with the Company’s business (any of which is referred to as a “Competitive Business”).

(ii) Have any interest in a Competitive Business.

(iii) Manage, operate, organize, or advise in any manner, or provide or arrange a Competitive Business.

Notwithstanding the foregoing, this limitation shall not apply to the acquisition of a stock interest in a publicly traded corporation that competes with the Company’s business. The previous sentence applies only if the stock is publicly traded and the stock so acquired (together with all other stock in the corporation beneficially owned by this Person and/or his spouse and any other member of his family) is not more than one percent (1%) of the outstanding shares of the corporation.

(b) Specific Enforcement. The parties agree that any breach or threatened breach of this Section x.x will cause irreparable injury to the Company and the other Members and that money damages will not constitute an adequate remedy. Accordingly, if any Member, Manager or Affiliate thereof breaches or threatens to breach this Section x.x, the Company and the other Members (in addition to all other rights and remedies available to them at law or in equity) may obtain equitable relief in the form of specific performance, temporary restraining order, temporary or permanent injunction or any other equitable remedy which may then be available from any court having equity jurisdiction, all without the need to post a bond or other security or to prove any amount of actual damage or that money damages will not provide an adequate remedy. This Section x.x is intended for the sole protection and benefit of the parties hereto and their respective successors and assigns. No other person or entity shall be the direct or indirect beneficiary of or have any direct or indirect cause of action or claim in connection of this Section x.x.

This is another typical provision:

(c) Managing Member. The Non-Managing Member acknowledges that the Managing Member and/or Affiliates of the Managing Member are engaged, directly and indirectly, in development of the “Trona Project.” This project includes (among other things) residential, office and commercial developments. Portions of the development will compete
directly or indirectly with the Property for tenants and buyers. The Non-Managing Member acknowledges that the Managing Member may continue to be engaged directly and indirectly in these developments. Neither the Company nor the Non-Managing Member has any right by virtue of this Agreement in and to these ventures or the income or profits derived from these developments. Except as specifically set forth in this Agreement, membership in the Company shall be without prejudice to the Managing Member’s rights (or the rights of its Affiliates) to have the other interests and activities and to enjoy profits or compensation therefrom.

121. Business Opportunities.

Address business opportunities that a partner is offered and that have a nexus to the business or assets of the partnership. The partnership agreement may require partners to offer business opportunities to the partnership if the opportunities are within the purpose of the partnership. In the absence of agreement partners normally required to offer competitive business opportunities to the partnership. Some partnership agreements have complex provisions under which other partners must be offered to participate in business opportunities relating to the business of the partnership. This often takes the form of an obligation to create a coinvestment partnership. Alternatively, your partnership agreement may permit partners to pursue these business opportunities without offering them to the partnership or its partners. Additional covenants might address soliciting business from partnership customers and soliciting or hiring partnership employees.

This is a simple provision concerning business opportunities:
Section x.x. Business Opportunities.

No Member and no Affiliate of a Member has any right (by virtue of this Agreement or otherwise) to share or to participate in or to approve any other investments or activities of any other Member. No Member and no Affiliate of a Member has any right to share in the income or proceeds derived from these investments or activities.

No Member and no Affiliate of any Member shall be obligated to offer or to bring to the attention of the Company or to any other Member any real property or other business investment or opportunity (whether or not within the scope of the Company’s purposes).

Any Member and any Affiliate of any Member (at any time during the term of the Company) may own, may invest in, may develop or may manage (directly or indirectly) any real property or other business investment or opportunity (whether or not competitive with the Company or its assets or otherwise within the scope of the Company’s purposes).

Each Member acknowledges that Members and their respective Affiliates have owned and have invested in, currently own and invest in, and in the future will be offered, will consider, will engage in and/or will invest in other businesses or real property ventures of every kind and nature. These businesses and ventures include (without prejudice to generality) the ownership, acquisition, financing, leasing, operating, management, syndication, brokerage and development of real property and other investments that are within the scope of the Company’s purposes or are or may be competitive with the Company.

Neither the Company nor any of the other Members nor their Affiliates has any obligation or responsibility to disclose, to account for, or to offer any real properties or other investments to the Company, any Member or their Affiliates.

The Company and the Members and their Affiliates have no rights or interests therein except as expressly set forth in this Agreement.

122. Accounting Method.

The accounting method of a partnership often is determined under tax rules. Address the partnership’s accounting method – which usually will be either the cash receipts and disbursements method or the accrual method.

The tax laws generally require a partnership with a C corporation as a partner or a partnership that is classified as a “tax shelter” to use the accrual method of accounting. The tax laws provide exceptions. The formal rules are gen-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

erally set forth in Section 448 of the Internal Revenue Code and Treasury Regulations under Section 448.

A partnership cannot use the cash receipts and disbursements method of accounting unless that method is authorized under Section 448.

The limitations concerning partnerships with a C corporation as a partner do not apply if the partnership –

- Is engaged in any farming business, or
- Meets a $5,000,000 gross receipts test set forth in Section 448(c).

The limitations for a partnership with a C corporation as a party do not apply to a partnership for any taxable year if, for all prior taxable years beginning after December 31, 1985, the partnership (or any predecessor) met the $5,000,000 gross receipts test. A partnership meets the $5,000,000 gross receipts test for any prior taxable year if the average annual gross receipts of the partnership for the three-taxable-year period ending with the prior taxable year do not exceed $5,000,000. Gross receipts for any taxable year are reduced by income tax returns and allowances made during such year.

A “tax shelter” is defined as —

- Any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale,
- Any syndicate (as defined in Internal Revenue Code Section 1256(e)(3)(B)), and
- Any tax shelter (as defined in Internal Revenue Code Section 6662(d)(2)(C)(iii)).

A “syndicate” means any partnership or other entity if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs.

A “limited entrepreneur” is a person who –

- Has an interest in an enterprise other than as a limited partner, and
- Does not actively participate in the management of such enterprise.

---

777 I.R.C. § 461(i)(3)
778 Other than a corporation which is not an S corporation.
A “tax shelter” means—

- A partnership or other entity,
- Any investment plan or arrangement, or
- Any other plan or arrangement,

if a significant purpose of the partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

123. Taxable Year.

The taxable year of a partnership is determined by statute. Section 706 of the Internal Revenue Code gives extensive rules for determining the taxable year of a partnership. The tax rules provide that a partnership does not have a taxable year other than—

- The majority interest taxable year,
- If there is no taxable year described in the first clause above, the taxable year of all the principal partners of the partnership, or
- If there is no taxable year described in the previous two clauses, the calendar year unless the Secretary by regulations prescribes another period.

Additionally, the partnership is permitted to have another taxable year if it established an adequate business purpose to the IRS. Further rules are set forth in Treasury Regulations.

In undertaking the determination of the partnership’s taxable year, a “principal partner” is a partner having an interest of 5 percent or more in partnership profits or capital. Tax rules do not clarify precisely how profits and capital are determined as percentages in the case of complex economic arrangements.

“Majority interest taxable year,” as used above, means the taxable year (if any) which, on each testing day, constituted the taxable year of 1 or more partners having (on such day) an aggregate interest in partnership profits and capital of more than 50 percent. The testing days are: (i) the 1st day of the partnership taxable year, or (ii) the days during such representative period as the Secretary may prescribe.

---

780 I.R.C. § 464(e)(2).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Further rules concerning determining the partnership’s taxable year are set forth in Treasury Regulations Section 1.706-1.


Related party transaction, not approved by the other partners, can violate a partner’s fiduciary duty of loyalty to the partnership. This is a simple provision considering related party transactions:

Section x.x. Transactions between the Company and the Members or their Affiliates.

(a) Contracts with Affiliates. Notwithstanding that it may constitute a conflict of interest, the Members may engage (and may cause their Affiliates to engage) in any transaction (including (without prejudice to generality) the purchase, sale, lease or exchange of any property, the lending of money, the rendering of any service or the establishment of any salary, other compensation or other terms of employment) with the Company. A transaction of these types is permitted only so long as that transaction is not expressly prohibited by this Agreement and so long as the transaction is conducted on arms’ length terms. All transactions between Members, or their Affiliates, and the Company which involve payments by the Company of amounts in excess of ***** must be approved by the affirmative vote or written consent of Members constituting a Majority in Interest of all Members that are not (and whose Affiliates are not) party to the transaction.

(b) Treatment of Affiliate Loans and Fees. To the fullest extent permitted by law, all principal, interest, costs and expenses owing by the Company to the Members, the Manager and/or Affiliates and all fees, commissions and/or reimbursable amounts payable by the Company to the Members, the Manager and/or Affiliates shall be treated in the same manner as liabilities payable to unaffiliated creditors of the Company and shall be paid and taken into account, as such, before any Distributions of Distributable Cash are made to the Members.

This is another typical provision:

Section x.x. Related Transactions Generally Prohibited. Except as expressly approved in this Agreement, in the Approved Budget, in an Annual Business Plan or otherwise, neither the Manager nor any Member shall engage or pay (or cause the Company to engage or pay) any compensation to any Member or any Affiliate of the Member for the provision of services to the Company unless (i) the party providing services is fully qualified and experienced to provide the required services; (ii) the scope
of services, the terms and conditions of and the compensation payable to
the Member or Affiliate for the services are consistent with then current
market standards for arms’ length transactions with an unrelated and un-
affiliated third party; (iii) the Member discloses the engagement to the
other Member or Members and the Manager as a transaction between the
Company and the Member or its Affiliate; and (iv) the Members approve
the engagement or payment by unanimous written consent.

125. Bank Accounts.

Your partnership agreement may require that partnership bank accounts be
held in a particular bank or with a bank meeting certain financial criteria. Your
partnership agreement often will require that partnership funds be deposited separa-
tely from the funds of partners. Your partnership agreement often will specify
who can sign checks on partnership bank accounts. This is a typical simple provi-
sion:

Section x.x. Bank Accounts. All receipts, income and funds of the Com-
pany shall be deposited in the name of the Company, in the account or ac-
counts (including interest bearing accounts) of the Company as may be
determined by the Managers (in their sole and absolute discretion). Com-
pany funds shall not be commingled with the funds of any other Person.
All withdrawals from Company accounts shall be made upon checks
signed by (or wire transfer authorized by) those Persons and in the man-
ner as the Managers may determine.

This is a medium-length provision:

Section x.x. Bank Accounts. The funds of the Company shall be deposi-
ted in the name of the Company in the bank account or accounts and at the
depository institutions as may be approved by the Members. The Manager
shall invest the funds (except for amounts used in the operation of the
business or held for distribution) in such high quality, short term instru-
ments as may be approved by the Members. The Manager or its designees
shall be the signatory on all Company accounts. The signature of the
Manager or its designees shall be sufficient to make withdrawals. The
Manager has fiduciary responsibility for the safekeeping and use of all
funds of the Company. The funds of the Company shall not be commingled
with the funds of the Manager or any other Person. The Manager shall not
employ the funds of the Company in any manner except for the benefit of
the Company and in accordance with this Agreement.

This is a more detailed provision:

Section x.x. Bank Accounts.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(a) Property Account. The Manager shall deposit (or cause the
Property Manager to deposit) all cash balances derived from rents or occu-
pancy payments or otherwise arising from ownership of the Property, in
a bank account established in the name of the Company by the Manager,
or the Property Manager (the “Property Account”).

(b) Development Account. In connection with the Project, the
Company shall establish (or shall cause the Developer to establish) a se-
parate interest-bearing bank account (the “Development Account”) for the
Project in the name of the Company. To the extent that the Project is fund-
ed by a Construction Loan, any disbursements requested by the Company
shall be deposited directly in the Development Account.

(c) Use of Funds. The Manager has fiduciary duties for the
safekeeping and use of all funds and assets of the Company over which it
has control. The funds of the Company shall not be commingled with the
funds of any other Person. The Members and the Manager shall not em-
ploy (nor shall it permit the Property Manager or Developer to employ)
the funds in any manner except for the benefit of the Company. Any in-
vestment of funds shall be made in the name of the Company. Any inves-
tment of funds shall be consistent with investment guidelines stated in an
Annual Business Plan or otherwise approved by Member consent. The
Company shall be a signatory on all accounts maintained with respect to
the Property. The Non-Managing Member has the right to require that its
signature be required on all checks/withdrawals. Upon an Event of De-
fault by the Managing Member or the Manager, the Non-Managing Mem-
ber (in its sole and absolute discretion and without limiting any other right
or remedy available to the Non-Managing Member under this Agreement,
or otherwise) may remove the Manager and the Managing Member as a
signatory on all accounts maintained with respect to the Property. There-
after, the Non-Managing Member shall be the sole signatory on all
checks/withdrawals.

(d) Deposit of Accounts. The Property Account and Develop-
ment Account shall be deposited in one (1) or more interest-bearing ac-
counts (which accounts are solely the property of the Company), with any
state or national bank with assets in excess of Twenty Five Billion Dollars
($25,000,000,000.00) whose deposits are insured by the Federal Deposit
Insurance Corporation, or invested in United States government securi-
ties, repurchase agreements secured by obligations of the United States or
its agencies, or invested in the interest-bearing accounts at one (1) or
more commercial banks having a Moody’s rating of “A” or better on long
term debt, or invested in commercial paper having a rating of “A-1” or
“P-1” or other investments and securities issued or fully guaranteed by
the United States or its agencies, with average maturities of, or redeemable in, not more than one hundred eighty (180) days.

126. Offset.

Section x.x. Offset Privilege. The Company may offset against any monetary obligation owing from the Company to any Member any monetary obligation then owing from that Member to the Company.

The partnership may wish to offset amounts owing to the partnership from a partner against distributions or other payments to be made to the partner. The provision quoted above is intended to create such an offset right. Consider, however, limitations that may be imposed on offset rights if the partner is in bankruptcy.

127. Remedies for Breach.

Your partnership agreement may set forth remedies for breach. Counsel should consider whether these remedies might be preempted by local law concerning liquidated damages clauses or bankruptcy doctrines. There often is a youthful exuberance in designing contractual remedies for punishing a partner who breaches or defaults under a partnership agreement. The value of these remedies is questionable if a court will not enforce them, regardless of what state law provides. Consider whether remedies will be enforced in a local state court. Consider whether remedies will be enforced against a partner who may be in bankruptcy. As a general matter, it is easier to enforce nonpunitive provisions than punitive provisions. Punitive provisions that harshly punish a default could be considered liquidated damage provisions. A state court might determine that local law concerning liquidated damages provisions in contracts prevails over the partnership law of the jurisdiction of the formation of the partnership. A bankruptcy court might determine that certain clauses that punish a debtor on account of his bankruptcy or financial condition are void bankruptcy *ipsa facto* clauses under Section 365(b)(2) of the Bankruptcy Code. Punitive remedies interfere with the power of the trustee to assume or to reject an executory contract.

These are common remedies in case of a default in a capital contribution (by no means a comprehensive list):

---

783 Consider carefully whether the remedies that you choose can be enforced.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and
Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The nondefaulting partners can revoke the capital contribution call and will receive return of their own additional capital contributions.

- Nondefaulting partners can lend the amount in default to your partnership. This amount often is treated as a demand loan from the partners to the defaulting partner, followed by a capital contribution by that partner.

- Nondefaulting partners can seek to arrange a loan from a third party lender to the partnership or a deemed loan to the defaulting partner (followed by a deemed capital contribution by that partner).

- Nondefaulting partners can convert their own corresponding capital contributions to loans to the partnership.

- The default may be an event that causes the application of a buy-sell provision of your partnership agreement.

- The default may be an event that causes the buy-out of the defaulting partner by the partnership, possibly at a discounted purchase price.

- The nondefaulting partners can purchase the partnership interest of the defaulting partner for an amount and upon terms specified in your partnership agreement.

- The default may permit nondefaulting partners to cause the liquidation of the partnership.

- The defaulting partner may be converted to a limited partner.

- The nondefaulting partners can make a capital contribution of the amount in default and receive a guaranteed payment on that amount.

- The defaulting partner loses his management rights or voting rights.

- The defaulting partner forfeits his partnership interest.

- The nondefaulting partners are permitted to make the capital contribution of the defaulting partner and partnership interests are adjusted by formula. There may be a capital shift incident to the adjustment.

- The partnership can sue the defaulting partner on account of his default.

Remedies are limited by the limits of your creativity and the willingness of state courts and bankruptcy courts to enforce these remedies. You are discouraged from providing for corporal punishments (for example, stripping a defaulting
partner naked, planting him in an ant hill, and painting his face with honey) – regardless of how much corporal punishment may be deserved. Courts are unlikely to enforce corporal remedies. Besides, better uses for honey are available. Remedies that are the economic equivalent of these corporal punishments may not be enforced by a court.

Partnership agreements often have elaborate provisions addressing defaults in additional capital contributions. These provisions often lead to dilution or super-dilution of the partnership interest of a defaulting partner, among other things. These provisions can be grouped into several groups. Some advisors prefer not to incorporate dilution provisions. Some advisors prefer for the partnership to cause the forfeiture the partnership interest of a defaulting partner or to retire the partnership interest for payments. These advisors advise that it is better to remove a defaulting partner and to buy-out his partnership interest. These advisors feel that it is difficult to continue partnership operations with a disgruntled (and often litigious) partner who has defaulted on an additional capital contribution obligation. A default on a call for additional capital often portends that your partnership is headed for troubled times.

The simple provision below is typical of a lightweight provision requiring superdilution of a partner’s interest in the partnership on account of a defaulted capital contribution:

Section x.x. Default by Member – Dilution, Etc. When a Member or Manager (a “Defaulting Party”) has failed to make a Mandatory Contribution as and when due, that Defaulting Party shall be subject to any one (but only one) of these remedies (which remedy shall be selected by the Manager):

(a) Purchase of Defaulting Party’s Interest. The Company (and/or the other Members) may elect to purchase the Defaulting Party’s interest in the Company in accordance with this Section y.y. This includes (without prejudice to generality) the provisions which allow actual damages up to the amount of the unpaid contribution to be deducted from the required purchase price for the Defaulting Party’s interest in the Company.

(b) Dilution. The Percentage Interests of the Defaulting Party and the other Members may be adjusted in accordance with Exhibit X.

(c) Actual Damages. The Defaulting Party may be held liable for actual damages (but not consequential, incidental damages or other damages) arising from the Default.

The dilution provisions of Exhibit X might provide:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

When a Member fails to make a Mandatory Contribution and/or a Member makes a Voluntary Contribution, the Percentage Interest of the Member shall be adjusted in accordance with these rules:

1. The Percentage Interest of a Member will equal the ratio of the Deemed Capital Contribution (as defined below) of that Member to the aggregate Deemed Capital Contributions of all Members.

2. Upon the formation of the Company, a Member who makes a Capital Contribution will be credited for each dollar contributed to the Company (each, a “Deemed Capital Contribution”). If a Member is not required to make an initial Capital Contribution proportionate to that Member’s initial Percentage Interest, the Member shall be credited with a Deemed Capital Contribution equal to the amount necessary for the Member’s Percentage Interest under the formula in Paragraph 1 above to be equal to the bargained for initial Percentage Interest.

3. Following the initial calculation of each Member’s Deemed Capital Contribution under Paragraph 2 above (or following any subsequent recalculation of the Deemed Capital Contribution of the Members under any other Paragraph of this Schedule 3.2 (as applicable) if a Voluntary Contribution is thereafter made by a Member), that Member will receive additional Deemed Capital Contributions equal to the number of dollars actually contributed by the Member at that time. The Percentage Interest of the Members will automatically adjust under Paragraph 1.

4. Following the initial calculation of each Member’s Deemed Capital Contribution under Paragraph 2 above (or following any subsequent recalculation of the Deemed Capital Contribution of the Members under any other Section of this Exhibit X (as applicable) if a Member fails to make any portion of a Mandatory Contribution as and when due) the Contributing Members elect to contribute a portion of the amount that was to be contributed by the Defaulting Member and the remedy at Section x.x is elected, then these computations shall apply:

   a. First, each Member shall receive additional Deemed Capital Contribution equal to the number of dollars actually contributed by the Member at that time.

   b. Then (subject to the last sentence of this subparagraph 4(b)), the balance of each Defaulting Member’s Deemed Capital Contribution shall be reduced by an amount equal to the product of the Defaulting Member’s Deemed Capital Contribution immediately prior to its failure to make the Mandatory Contribution multiplied by the number (which is no event shall be less than zero):
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

\[
1 - \frac{1.3 \times C}{D}
\]

where:

\( C \) = the amount of the Capital Contribution that the Defaulting Member failed to contribute, expressed in dollars, and

\( D \) = the aggregate Capital Contributions to the Company that would have been made by the Defaulting Member had all required Capital Contributions (including the Capital Contribution that caused the application of this Exhibit) been made by the Member, expressed in dollars, and for this purpose only, the amount of Deemed Capital Contribution issued under Paragraph 2 to a Member which did not contribute actual capital shall be deemed to be capital and thus shall increase the amount \( D \).

d. Finally, the Deemed Capital Contribution that is removed from a Defaulting Member under subparagraph 4(b) shall be redistributed among, and added to the balance of, the Deemed Capital Contribution of the Contributing Members.

d. Each Contributing Member shall receive Deemed Capital Contribution equal to the product of the Deemed Capital Contribution removed from a Defaulting Member multiplied by a fraction, the numerator of which is the portion of the amount of \( C \) in Paragraph 4(b) that was contributed by the Contributing Member at that time (expressed in dollars) and the denominator of which is the total amount of \( C \) above contributed by all Contributing Members at that time (expressed in dollars).

d. In all cases, the Manager shall adjust the Percentage Interest of the Members so that the Percentage Interests of the Members total 100%, and the Percentage Interest of each Member shall be rounded (as a percentage) to the fifth decimal point.

This is another simple provision:

Section x.x. Capital Call; Default by Member.

\( (a) \) If a Manager makes a written call for Additional Contributions ("Capital Call Notice") under Section x.x and any Member fails to timely make an Additional Contribution to the Company, then the Manager making the call immediately shall give all Members notice of the fact.

\( (b) \) Within ten (10) business days after the Capital Call Notice is given, any one or more of the Members who did not default in making the Additional Contribution required of it or them, if any (whether one or
more the “Non-Defaulting Member”), may pay (at its option) to the Com-
pany an amount equal to the Additional Contribution (the “Defaulted
Amount”) the defaulting Member(s) (whether one or more the “Defaul-
ting Member”) failed to make.

(c) If there is more than one Non-Defaulting Member, then the
right shall be exercisable by them in proportion to their Percentage Inter-
est. The Non-Defaulting Members may make other agreements among
themselves as to the portion of the Defaulted Amount to be paid by each of
them.

(d) Any Non-Defaulting Member that pays to the Company the
Defaulted Amount shall be referred to (whether one or more) as the “Con-
tributing Member.” The amount shall be treated as an Additional Contri-
bution by the Contributing Member. The Percentage Interest(s) of the De-
faulting Member shall be diluted in accordance with the dilution formula
specified below.

(e) Effective as of the date when contribution of the Defaulted
Amount is made, the Percentage Interest(s) of the Defaulting Member (as
a group) immediately prior to dilution shall be decreased to the percent-
age that the total Capital Contributions made by the Defaulting Member
from the inception of the Company is of the total Capital Contributions
made by all Members from the inception. All payments of Defaulted
Amounts are treated as Additional Contributions under this Section x.x at
three hundred percent (300%) of the Defaulted Amounts (so that the con-
tribution of $100 of Defaulted Amounts shall be treated as the contribu-
tion of $300).

(f) Upon dilution, the Percentage Interest of the Contributing
Member shall be increased by (i) the difference between the aggregate
Percentage Interest(s) of the Defaulting Member immediately prior to the
dilution and (i) the Percentage Interest(s) of the Defaulting Member im-
mediately after the dilution. The total Percentage Interests of all Members
shall equal 100%.

(g) When the Defaulting Member is comprised of more than
one Member, the dilution shall be borne by the Members in proportion to
their Percentage Interests immediately prior to the dilution.

(h) If the Contributing Member is comprised of more than one
Member, then the dilution of the Defaulting Member’s Interest shall inure
to the benefit of the Members in proportion to the part of the Defaulted
Amount paid by each of them.

(i) If no Non-Defaulting Member elects to pay the Defaulted
Amount, then the Company and any Non-Defaulting Member shall each
have the right to sue the Defaulting Member on account of the breach of its covenants set forth in Section x.x to make Additional Contributions.

Dilution provisions often increase the partnership interest of the partner making a capital contribution on behalf of a defaulting partner. They correspondingly diminish the partnership interest of the defaulting partner. If you use a dilution provision, be clear whether the dilution provision resets and readjusts interests both in profits and losses. Be clear whether the dilution provision resets and readjusts capital accounts. Make sure that the dilution provision properly coordinates with all of the special distribution and allocation provisions in your partnership agreement. Take out your slide rule and run numbers (or have the partnership accountants or financial analysts run numbers) in advance (with hypothetical numbers) on how the dilution provision will work. Consider an array of situations.

Dilution provisions often are based on capital contributions. A dilution provision might recalculate percentage interests based on the ratio of the capital contributions made by all partners (including the defaulted capital contribution). This might make superficial sense; however, it fails to recognize the timing of the different contributions and the fact that earlier capital contributions have been at work and at risk for a longer time than the most recent capital contributions. If the partnership has one or more service partners, the dilution provision needs to make special accommodations or the service partner can suffer from the readjustment of percentage interests. The service partner might be credited with a hypothetical capital contribution for purposes of readjusting percentage interests. Consider basing the adjustment of percentage interests on the fair market values of the respective partnership interests (measured at the time of the adjustment) and the capital that partners are contributing (measured at the time of adjustment). Such a provision would force the partners to incur the expense of valuing partnership assets.

A basic accounting identity holds that Partnership Assets = Partnership Liabilities + Partner Capital Accounts. A single partner’s capital account is thought to represent his equity in your partnership. Partnership agreements often require that the proceeds of liquidation of the partnership be distributed to partners in accordance with their final positive capital account balances.

A dilution provision that resets and readjusts capital accounts may have undetermined tax consequences that could create taxable income to the partner to whom capital is shifted. Consider shifting an interest in profits to the contributing partner, but not shifting the interest in losses. (This may be ineffective in the absence of a capital account readjustment, since the shift in future “profits” may represent, in part, an allocation of currently existing unrealized appreciation.) Consider not transferring a negative capital account to a partner making a defaulted capital contribution of another partner. Consider special allocations and income chargebacks (including the minimum gain chargeback) in drafting the dilution clause. A provision in your partnership agreement requiring a substantial charge-
back of prior losses may vitiate the effects of a dilution provision. A shift of a portion of a defaulting partner’s negative capital account to a contributing partner may not make economic sense. Run numerical examples to test the dilution provision and to ensure that your dilution provision produces acceptable economic results. A dilution provisions needs to be rethought and redrafted to address each individual situation.

Many dilution provisions work satisfactorily for the first default. They often do not work satisfactorily if several different defaults occur at different times. This can particularly be a problem with dilution provisions that give extra credit to partners making the defaulted capital contribution of another partner. Make sure to take out your slide rule and run numbers to ensure that your dilution provision will work repeatedly if multiple defaults occur.

Dilution provisions commonly fail to consider the time when different capital contributions are made by partners. Dilution provisions commonly treat a capital contribution made several years ago (or even several decades ago) on par with a capital contribution made today. Dilution provisions commonly fail to consider the fair market value of partnership interests (measured at the time when those dilution provisions operate). The sample provision takes into account capital contributions, without considering when they were made or giving any consideration to the value of the partnership interests (measured at the time when additional capital contributions are made). This provision fails to consider distributions in return of capital. Dilution provisions often fail to consider appreciation or depreciation in partnership assets after the formation of the partnership. Dilution provisions usually are a rough justice way of recalculating percentage interests in the venture. They rarely are economically fair. They may be intended not to be economically fair. If you seek to design an economically fair dilution provision, consider revaluing capital accounts based on the current fair market value of partnership assets and use these revalued capital accounts in designing a dilution provision.

Dilution provisions often penalize a defaulting partner for defaulting on his additional capital contribution obligation. Consider, in designing a provision to coerce the partner to satisfy a capital contribution obligation, that a court may be reluctant to enforce provisions that act as penalties. Delaware limited liability company law, for example, permits penalty provisions, but another state court might refuse to enforce this aspect of Delaware limited liability company law. A Bankruptcy Court similarly might refuse to enforce this aspect of Delaware limited liability company law. Although some partnership acts permit penalty provisions, the status of penalty provisions approved by these acts under bankruptcy law or under laws of other states is still to be determined.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Consider whether the dilution provision should affect capital. Consider whether the dilution provision should affect loss allocations. Consider whether the dilution provision produces a disguised sale of partnership interests.

Consider the instant at which the dilution provision should be effective and the effect of the altered percentage interests on allocations and distributions during the partnership’s taxable year of the dilution adjustment. Clearly indicate the instant of effectiveness of the adjusted percentages. 784

Delaware limited liability company law provides:
§ 18-306. Remedies for breach of limited liability company agreement by member. A limited liability company agreement may provide that:

(1) A member who fails to perform in accordance with, or to comply with the terms and conditions of, the limited liability company agreement shall be subject to specified penalties or specified consequences; and

(2) At the time or upon the happening of events specified in the limited liability company agreement, a member shall be subject to specified penalties or specified consequences.

Such specified penalties or specified consequences may include and take the form of any penalty or consequence set forth in § 18-502(c) of this title. Delaware Limited Liability Company Act § 18-306.

Delaware Limited Liability Company Act § 18-306.

Delaware limited liability company law provides:
§ 18-502. Liability for contribution.

(a) Except as provided in a limited liability company agreement, a member is obligated to a limited liability company to perform any promise to contribute cash or property or to perform services, even if the member is unable to perform because of death, disability or any other reason. If a member does not make the required contribution of property or services, the member is obligated at the option of the limited liability company to contribute cash equal to that portion of the agreed value (as stated in the records of the limited liability company) of the contribution that has not been made. The foregoing option shall be in addition to, and not in lieu of, any other rights (including (without prejudice to generality) the right to specific performance) that the limited liability company may have against such member under the limited liability company agreement or applicable law.

(b) Unless otherwise provided in a limited liability company agreement, the obligation of a member to make a contribution or return money or other property paid or distributed in violation of this chapter may be compromised only by consent of all the members. Notwithstanding the (footnote continued on the next page)
compromise, a creditor of a limited liability company who extends credit, after the entering into of a limited liability company agreement or an amendment thereto which, in either case, reflects the obligation, and before the amendment thereof to reflect the compromise, may enforce the original obligation to the extent that, in extending credit, the creditor reasonably relied on the obligation of a member to make a contribution or return. A conditional obligation of a member to make a contribution or return money or other property to a limited liability company may not be enforced unless the conditions of the obligation have been satisfied or waived as to or by such member. Conditional obligations include contributions payable upon a discretionary call of a limited liability company prior to the time the call occurs.

(c) A limited liability company agreement may provide that the interest of any member who fails to make any contribution that the member is obligated to make shall be subject to specified penalties for, or specified consequences of, such failure. Such penalty or consequence may take the form of reducing or eliminating the defaulting member’s proportionate interest in a limited liability company, subordinating the member’s limited liability company interest to that of nondefaulting members, a forced sale of that limited liability company interest, forfeiture of the defaulting member’s limited liability company interest, the lending by other members of the amount necessary to meet the defaulting member’s commitment, a fixing of the value of the defaulting member’s limited liability company interest by appraisal or by formula and redemption or sale of the limited liability company interest at such value, or other penalty or consequence.

Delaware Limited Liability Company Act § 18-502.

Section 365 of Title 11 (Bankruptcy Act) provides in pertinent part:

(a) Except as provided in sections 765 and 766 of this title and in subsections (b), (c), and (d) of this section, the trustee, subject to the court’s approval, may assume or reject any executory contract or unexpired lease of the debtor.

(b) 

(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—

(A) cures, or provides adequate assurance that the trustee will promptly cure, such default;

(B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

**128. Expulsion.**

One of the most difficult provisions in a partnership agreement involves expulsion of a partner. Expulsion provisions should be drafted with particular care. Expulsion of a partner often leads to litigation and often will end up with the participation of an arbitrator or the courts. The partnership agreement should address how a partner is expelled and what the expelled partner received in exchange for his partnership interest.

The Delaware Limited Liability Company Act does not address expulsion, but it does implicitly recognize the possibility of expulsion by providing that “the death, retirement, resignation, expulsion, bankruptcy or dissolution of any member or the occurrence of any other event that terminates the continued membership of any member shall not cause the limited liability company to be dissolved or its affairs to be wound up, and upon the occurrence of any such event, the limited liability company shall be continued without dissolution.”

The Revised Uniform Limited Liability Company Act Section 602 permits expulsion of a member, among other things, upon:

- The person being expelled as a member pursuant to the operating agreement.

---

785 Delaware Limited Liability Company Act § 18-801(b) (emphasis added).

786 Revised Uniform Limited Liability Company Act Section 602 does not explicitly limit the grounds that can be set forth in the operating agreement for expulsion of a member. Also consider the effects of a bankruptcy of the member on the ability of the limited liability company to expel the member.
The person is expelled as a member by the unanimous consent of the other members if:

- It is unlawful to carry on the company’s activities with the person as a member.
- There has been a transfer of all of the person’s transferable interest in the company, other than:
  - A transfer for security purposes. or
  - A charging order in effect under Section 503 which has not been foreclosed.
- The person is a corporation and, within 90 days after the company notifies the person that it will be expelled as a member because the person has filed a certificate of dissolution or the equivalent, its charter has been revoked, or its right to conduct business has been suspended by the jurisdiction of its incorporation, the certificate of dissolution has not been revoked or its charter or right to conduct business has not been reinstated. or
- The person is a limited liability company or partnership that has been dissolved and whose business is being wound up.

On application by the company, the person is expelled as a member by judicial order because the person:

- Has engaged (or is engaging) in wrongful conduct that has adversely and materially affected (or will adversely and materially affect) the company’s activities.
- Has willfully or persistently committed (or is willfully and persistently committing) a material breach of the operating agreement or the person’s duties or obligations under Section 409. or
- Has engaged in (or is engaging in) conduct relating to the company’s activities which makes it not reasonably practicable to carry on the activities with the person as a member.

To the extent a burden on a partner (for example, expulsion) results from the partner’s bankruptcy, consider whether a bankruptcy court will enforce the burden.
129. **Time Devoted to Partnership Affairs.**

Clarify how much time partners are required to devote to partnership business and affairs. Consider:

*The General Partner shall devote his full productive time and efforts to the management and control of the Partnership and its affairs.*

The provision alternatively might provide:

*The General Partner is required to devote to the management and control of the Partnership only so much of his time as the General Partner (in its sole and absolute discretion) deems necessary to promote the best interests of the Partnership.*

130. **Arbitration.**

Arbitration and other nonjudicial forums are particularly useful for partnership disputes on account of the common desire to keep partnership disputes confidential. Consider providing for such a forum for dispute resolution in your partnership agreement. A well-drafted arbitration provision is comprehensive and does more than waive an arbitration flag.

Consider these issues:

- What matters are subject to arbitration?
- Does the arbitrator determine the arbitrability of disputes?
- What arbitration rules are to be used?
- Where is the arbitration to take place?
- Is the arbitration intended to be final, or are decisions appealable?
- What is the procedure for commencing arbitration?
- How is the arbitrator selected?
- What qualifications must the arbitrator have?
- Are there time requirements for the arbitration?
- What rules of discovery apply to the arbitration?
- What substantive law (if any) is the arbitrator required to apply?
- What limitations are imposed on parties to proffer written or oral evidence?
- Will there be provision for stipulated facts?
- Are parties to submit trial briefs?
Is the arbitrator required to submit a reasoned award? Must it be in writing?

How shall the arbitrator award costs of arbitration?

Is there an agreed venue for enforcement proceedings?

Is the arbitration confidential?

Is arbitration the exclusive forum for hearing disputes?

This is a simple, basic arbitration provision of a type that might be found in a partnership agreement:

Section x.x Arbitration.

(a) Arbitration.

(i) Any dispute between the parties concerning the Company shall be resolved by and through an arbitration proceeding ("Arbitration") conducted in accordance with this Section x.x.

(ii) This arbitration requirement shall apply to any dispute, claim or controversy between the parties arising out of (or in any way relating to) this Agreement or the Company or its assets.

(iii) This arbitration requirement shall apply whether the dispute, claim, or controversy arises in contract, tort, equity or otherwise.

(iv) This arbitration requirement shall apply whether the dispute, claim, or controversy relates to the meaning, interpretation, effect, validity, performance or enforcement of this Agreement or any matter relating to the Company, or its assets.

(v) The Arbitration shall be undertaken before a single arbitrator ("Arbitrator").

(vi) The Arbitration shall be conducted under the auspices and the commercial Arbitration rules then in effect ("Commercial Arbitration Rules") of the American Arbitration Association (or any like organization successor thereto).

(vii) The Arbitration shall be held at Los Angeles, California.

(viii) The arbitrability of this dispute, claim or controversy shall be determined in this Arbitration.

(ix) This Arbitration proceeding shall be conducted in as expedited a manner as is practicable by the Commercial Arbitration Rules and the procedures of the American Arbitration Association.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(x) Both the foregoing agreement of the parties to arbitrate any and all this disputes, claims and controversies, and the results, determinations, findings, judgments and/or awards rendered through any this Arbitration shall be final and binding on the parties to this Agreement.

(xi) This agreement to arbitrate may be specifically enforced by legal proceedings in any court of competent jurisdiction.

(b) Notice.

(i) This Arbitration may be initiated by written notice from any party to another party setting forth a demand for Arbitration and detailing with specificity the nature of the dispute, claim or controversy to be arbitrated.

(ii) This written notice shall include (without prejudice to generality)

(A) The general nature of this dispute, claim or controversy,

(B) The specific facts that support its contentions,

(C) References to the specific provisions of this Agreement that a party contends to be breached.

(D) A description of the nature of any breach.

(E) References to the specific provisions of any statute that a party contends to have been violated.

(c) Time is of the essence for these Arbitration procedures.

(d) The Arbitrator shall be requested to render his or her award within ten (10) days following the closing of the hearing.

(e) Discovery Rules.

(i) The parties and Arbitrator have all of the rights and duties relating to discovery provided by Section 1283.05 of the California Code of Civil Procedure (which is made a part of this Agreement).

(ii) Notwithstanding the foregoing sentence, the Arbitrator has the power to issue a protective order with respect to any discovery that the Arbitrator deems to be for purposes of delay or otherwise unnecessarily vexacious, burdensome or oppressive.
Qualifications of Arbitrator. The Arbitrator in any this Arbitration (insofar as is practicable) shall be an attorney who, for a continuous period of not less than ten (10) consecutive years,

(i) for a continuous period of not less than ten (10) consecutive years, has been admitted and engaged in the practice of law in Los Angeles, California, and

(ii) for a continuous period of not less than ten (10) consecutive years, has devoted at least one-half of his or her legal practice to matters of corporate law or partnership law, and

(iii) is currently licensed to practice law before the courts of the State of California.

Selection of Arbitrator.

(i) The parties shall seek to agree on a single Arbitrator meeting the qualifications set forth in Section x.x(d).

(ii) If the parties fail to reach agreement on a single Arbitrator (within ten (10) days of the notice set forth in Section x.x(b)), then the Arbitrator shall be selected in accordance with the rules of the American Arbitration Association.

Governing Law. The Arbitrator shall follow any applicable Federal law and Delaware law (with respect to all matters of substantive law) in rendering an award.

Opportunity to Present Evidence.

(i) Prior to rendering his or her determination or award, the Arbitrator shall afford each party an opportunity to express its views as to the proper determination of the matters under Arbitration, orally or in writing as the Arbitrator may deem appropriate.

(ii) Either party submitting written material shall be required to submit a copy of that material to the other party. The other party shall have the opportunity to submit a written reply to that material (within ten (10) days of receipt of the written material by the other party).

(iii) If either party is to submit oral statements, the other party shall be afforded a reasonable opportunity to be present at the time when these oral statements are made before the Arbitrator and to reply orally.

Procedure. The parties (while acknowledging that the Arbitrator has the authority to make the final determination concerning all
procedural matters of the Arbitration) jointly request that the following procedure be followed in conducting the Arbitration:

 (i) Within ten (10) days of the selection of the Arbitrator, the responding party must answer in writing the complaint set forth in the notice referred to in Section x.x(b).

 (ii) Trial of the Arbitration shall commence within sixty (60) days of the delivery of the notice referred to in Section x.x(b) unless the parties agree in writing to extend this time period or the Arbitrator extends the time for commencing trial.

 (iii) Prior to beginning of the trial, the parties shall prepare a joint statement of stipulated facts. This statement shall include all relevant facts upon which there is no dispute. This statement shall be submitted to the Arbitrator for his or her use and shall be binding upon the parties and the Arbitrator. This statement shall be submitted to the Arbitrator no more than five (5) days before the first day of trial.

 (iv) The parties may submit trial briefs to the Arbitrator (if they wish to do so). If a party desires to submit a trial brief, it shall do so no later than five (5) days prior to the first day of trial. The parties may supplement trial briefs by argument and supplemental points and authorities.

 (k) Reasoned Award.

 (i) The Arbitrator shall provide a reasoned award to the parties in writing at the close of the Arbitration.

 (ii) This reasoned award shall include (without prejudice to generality) a statement of facts that the Arbitrator has determined to be true during the course of the Arbitration, and the reasoning on which the award is based.

 (l) Costs of Arbitration. The unsuccessful party or shall bear these expenses, or the Arbitrator may prorate these expenses between the parties in this proportion as the Arbitrator determines to be equitable. The Arbitrator’s award shall include the Arbitrator’s apportionment and award of these expenses:

 (i) All costs of the Arbitration proceeding,

 (ii) Costs of any proceeding in court to confirm or to vacate any Arbitration award, as applicable,

 (iii) The administrative fees and charges of the American Arbitration Association,
 SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(iv) The fees and expenses of the Arbitrator, and
(v) Actual attorneys’ fees and costs.

(m) Venue and Jurisdiction. Any and all legal proceedings to
enforce this Section x.x shall be brought in any court of competent juris-
diction. This shall apply to (without prejudice to generality) any action to
compel Arbitration under this Agreement, or any action to enforce, to va-
cate or to modify any award or judgment rendered in the Arbitration

(n) Waiver of Jury Trial. The parties waive their right to trial
by jury with respect to any dispute, claim or controversy compelled by this
Section x.x.

(o) Confidentiality.

(i) The parties agree that they shall maintain the confi-
dentiality of any controversy or dispute arising under this Agreement and
shall not disclose any issue or allegation with respect to this controversy
or dispute to third parties, including (without prejudice to generality) the
nature of the controversy or dispute and its resolution.

(ii) All Arbitration proceedings shall be conducted in
secrecy.

(iii) All documents, testimony and records shall be re-
ceived, heard and maintained by the Arbitrator in secrecy under seal.

(iv) All documents, testimony and records shall be
available for inspection only by the parties and their respective attorneys
and experts,

(v) All parties and their respective attorneys and ex-
erts shall agree in advance in writing to receive all this information confi-
dentially and to maintain this information in secrecy.

(vi) None of the parties shall at any time issue a press
release or otherwise communicate with media representatives regarding
any dispute or controversy without first receiving prior written approval
of the other parties. This subsection x.x(o) shall not apply to court filings,
or any judicial proceedings necessary to compel Arbitration or to force, to
vacate or to modify the Arbitrator’s award.

(p) Exclusive Remedy. The parties agree that Arbitration as set
forth above shall be the sole means of resolving any disputes, claims and
controversies among them arising out of this Agreement.

(q) Survival. This Arbitration clause shall survive the termina-
tion of this Agreement.
(r) Additional Persons. The parties agree that any Arbitration arising out of or relating to this Agreement shall include, by consolidation, joinder or in any other manner, any additional person not a party to this Agreement if:

(i) Either party requests the addition of this person; and

(ii) The requesting party reasonably believes the addition of this person to be necessary to the resolution of the dispute between the parties; and

(iii) The additional person is a party to a contract with the requesting party (which contract contains the agreement of this additional party to be bound by the Arbitration provisions of this Agreement).

This is an even simpler and shorter arbitration provision:

Section x.x Arbitration. Any controversy or claim arising out of or in connection with this Agreement shall be finally resolved by arbitration pursuant to the Commercial Arbitration Rules of the American Arbitration Association. Any such arbitration shall take place in St. Louis, Missouri, before one or more arbitrators chosen in accordance with these Rules. The parties agree that (a) the arbitrator(s) shall be empowered to order injunctive relief and/or specific performance of the terms and conditions of this Agreement, as well as to include arbitration costs and attorneys’ fees in the award to the prevailing party in any arbitration proceeding, and (b) the award in the proceeding shall be final and binding on the parties. Judgment on the arbitrators’ award may be entered in any court having the requisite jurisdiction. Nothing in this Agreement shall require the arbitration of disputes between the parties that arise from actions, suits or proceedings instituted by third parties.

131. Conversion to a Corporation.

Some partnership agreement provide for the possible later conversion of the partnership to a corporation in connection with an initial public offering. This is a sample provision:

Section x.x. Conversion to a Corporation. Notwithstanding anything in this Agreement to the contrary, the Manager may cause the Company to be converted into a corporation under any method determined by the Manager in connection with the effectuation of a public offering of shares of common stock of the corporation. In this case, the Manager shall decide whether to issue shares of stock in the corporation that reflect (to the ex-
tent determined by the Manager) the relative rights of the different Inter-
ests, or to issue solely common stock of the corporation to the Members
based on their respective Liquidation Values immediately prior to the con-
version determined by assuming that the public offering will be consum-
mated as determined by the Manager. If different classes of shares are is-
sued, the Members shall enter into the shareholders agreements as may be
determined by the Manager to be necessary or appropriate to reflect their
respective rights and obligations. The Manager shall give a copy of its
written determination to the Members.


“Capital Account” of a Partner means the “capital account” of
that Partner determined under Section 1.704-1(b)(2)(iv) of the Treasury
Regulations.

“Capital accounts” perhaps are best encapsulated in these equations:

\[
\text{Assets} = \text{Liabilities} + \text{Capital Accounts}
\]
\[
\text{Capital Accounts} = \text{Assets} - \text{Liabilities}
\]

Treasury Regulations generally presume that a partner will receive the
amount in his capital account when the partnership liquidates or the partner’s in-
terest in the partnership is liquidated. This is an important principle of econo-
ic effect.

Treasury Regulations on partnership allocations to a significant extent are
based on a capital account analysis. Capital accounts represent the partners’ equi-

787 Treas. Reg. § 1.704-1(b)(2)(ii)(a), (b).
a. **Basic Rules.**

Capital accounts in general are:

- Increased (without double counting of adjustments) by –
  - The amount of money contributed by the partner to the partnership.
  - The fair market value of property contributed by the partner to the partnership (net of liabilities that the partnership is considered to assume or take subject to).
  - Allocations to the partner of partnership “book” income and gain\(^{788}\) (or items thereof) (including income and gain exempt from tax and income and gain described in Treasury Regulations Section 1.704-1(b)(2)(iv)(g) resulting from revaluation of partnership assets to fair market value on permitted events, but excluding income and gain described in Treasury Regulations Section 1.704-1(b)(4)(i) (income and gain resulting from “book”-tax disparities on account of the revaluation of assets on the books of the partnership)).

- Decreased (without double counting of adjustments) by –
  - The amount of money distributed to the partner by the partnership.
  - The fair market value of property distributed to the partner by the partnership (net of liabilities that the partner is considered to assume or take subject to).
  - Allocations to the partner of expenditures of the partnership described in Section 705(a)(2)(B) (“expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account”).
  - Allocations of partnership “book” loss and deduction\(^{789}\) (or items of “book” loss and deduction).\(^{790}\)

---

\(^{788}\) See discussion of “book” items in text accompanying note 505.

\(^{789}\) See discussion of “book” items in text accompanying note 9.

\(^{790}\) Treas. Reg. § 1.704-1(b)(2)(iv)(b). **Query:** what happens when a partner contributes an option to acquire property to the partnership and there is a substantial “book”-tax difference in the option. The option later is exercised and the optioned property is acquired as a substantial discount on account of the option.

(footnote continued on the next page)
A partner’s capital account is increased by the fair market of property that he contributes to the partnership. When the “book”-tax disparity is recognized as

What is the “book” value of the acquired property? What are the effects of the transaction on partners’ capital accounts? Note that the definition of “capital account” would be amended by the revaluation rules for exercise of partnership noncompensatory options under Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(h)(2) (“(s) Adjustments on the exercise of a noncompensatory option. A partnership agreement may grant a partner, on the exercise of a noncompensatory option (as defined in §1.721-2(d)), a right to share in partnership capital that exceeds (or is less than) the sum of the consideration paid by the partner to acquire and exercise such option. Where such an agreement exists, capital accounts will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless – (I) In lieu of revaluing partnership property under paragraph (b)(2)(iv)(f) of this section immediately before the exercise of the option, the partnership revalues partnership property in accordance with the provisions of paragraphs (b)(2)(iv)(f)(1) through (4) of this section immediately after the exercise of the option; (2) In determining the capital accounts of the partners (including the exercising partner) under paragraph (b)(2)(iv)(s)(1) of this section, the partnership first allocates any unrealized income, gain, loss, or deduction in partnership assets (that has not been reflected in the capital accounts previously) to the exercising partner to the extent necessary to reflect that partner’s right to share in partnership capital under the partnership agreement, and then allocates any remaining unrealized income gain, loss, or deduction (that has not been reflected in the capital accounts previously) to the existing partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in partnership property would be allocated among those partners if there were a taxable disposition of such property for its fair market value on that date; (3) If, after making the allocations described in paragraph (b)(2)(iv)(s)(2) of this section, the exercising partner’s capital account still does not reflect that partner’s right to share in partnership capital under the partnership agreement, then the partnership reallocates partnership capital between the existing partners and the exercising partner so that the exercising partner’s capital account does reflect the exercising partner’s right to share in partnership capital under the partnership agreement (a capital account reallocation). Any increase or reduction in the capital accounts of existing partners that occurs as a result of a capital account reallocation under this paragraph (b)(2)(iv)(s)(3) must be allocated among the existing partners in accordance with the principles of this section; and (4) The partnership agreement requires corrective allocations so as to take into account all capital account reallocations made under paragraph (b)(2)(iv)(s)(3) of this section (see paragraph (b)(4)(x) of this section). See Examples 20 through 24 of paragraph (b)(5) of this section.”).
income by the partnership, the “book”-tax disparity amount does not increase capital accounts. “Book” value already has been accounted for in capital accounts. This essentially means that gain associated with a “book”-tax disparity (Section 704(c) gain) does not increase capital accounts. Similarly, loss associated with a “book”-tax disparity (Section 704(c) loss) does not adjust capital accounts.

Capital accounts are adjusted by “book” income and “book” loss – computed first by reference to the fair market value of contributed property, adjusted in accordance with tax principles.\(^791\) Gain and loss associated with a “book”-tax disparity (Section 704(c) gain or loss) are excluded from adjusting capital accounts after partnership assets are contributed and booked at fair market value. A partnership can determine the fair market value of its assets and credit unrealized appreciation or debit unrealized depreciation to capital account at certain defined instants.

Capital accounts are reduced by the fair market value of distributed property.\(^792\) The capital accounts of the partners first must be adjusted to reflect the manner in which the unrealized gain or loss inherent in the distributed property (that has not been reflected in the capital accounts previously) would be allocated among the partners if the partnership makes a taxable disposition of the property for the fair market value of the property (taking Section 7701(g) into account) on the date of distribution.\(^793\)

The basic capital accounting rules require that a partner’s capital account be decreased by the fair market value of property distributed to him by the partnership (without regard to Section 7701(g)) whether in connection with a liquidation or otherwise. Capital accounts first must be adjusted (booked-up) to reflect the manner in which the unrealized income or loss inherent in the distributed property (that has not been reflected in the capital accounts previously) would be allocated among the partners if the partnership made a taxable disposition of the distributed property for the fair market value of the distributed property (taking Section 7701(g) into account) on the date of distribution.

References to liabilities (for liabilities assumed before June 24, 2003) include only liabilities secured by the contributed or distributed property that are

\(^{791}\) Treas. Reg. § 1.704-1(b)(2)(iv)(g).


\(^{793}\) Treas. Reg. § 1.704-1(b)(2)(iv)(e). Section 7701(g) provides: “For purposes of subtitle A, in determining the amount of gain or loss (or deemed gain or loss) with respect to any property, the fair market value of such property shall be treated as being not less than the amount of any nonrecourse indebtedness to which such property is subject.”
taken into account under the partnership rules for allocating partnership liabilities (Section 752(a) and (b)).

Capital accounts are adjusted by “book” income and loss. “Book” income and losses are income and loss computed under federal income tax principles computed by reference to the “book” value of the property. Adjusting capital accounts by “book” income and loss (rather than tax income and loss) avoids double counting of appreciation in contributed property. Capital accounts were initially credited with the fair market value of contributed property.

Revalued property cannot be booked down below the amount of any non-recourse liability to which the property is subject.794

A partner who has more than one interest in a partnership should have a single capital account that reflects all of his interests in the partnership. Apply this rule regardless of the class of interests owned by the partner (for example, general or limited, common or preferred, class A, class B, etc.) and regardless of the time or manner in which the interests were acquired.795

Elaborations and nuances and some uncertainties in maintaining capital accounts will tease tax professionals. These elaborations and nuances and uncertainties are generally beyond the scope of this Article.

b. Liabilities.

These rules apply for the treatment of liabilities in computing capital accounts:

- Money contributed by a partner to a partnership (increasing capital accounts) includes the amount of any partnership liabilities that are assumed by the partner but does not include increases in the partner’s share of partnership liabilities, and
- Money distributed to a partner by a partnership (decreasing capital accounts) includes the amount of the partner’s individual liabilities that are assumed by the partnership but does not include decreases in the partner’s share of partnership liabilities.796

Liabilities are considered assumed only to the extent –

- The assuming party is subjected to personal liability with respect to the obligation.

795 Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- The obligee is aware of the assumption and can directly enforce the assuming party’s obligation.

- As between the assuming party and the party from whom the liability is assumed, the assuming party is ultimately liable.797

Partner guarantees of partnership indebtedness do not directly affect capital accounts. A partner guaranteeing a partnership liability is not the same thing as a partner assuming a partnership liability.798

A partner’s share of partnership liabilities does not increase the partner’s capital account, but a share of partnership liabilities does not increase his tax basis in his partnership interest. This is important in keeping the partner from recognizing gain.

Recourse liabilities are liabilities with respect to which a partner or a partner affiliate bears the ultimate risk of loss.799 Partnership recourse liabilities are shared among the partners in accordance with the manner in which they bear the

---


798 Extensive rules for allocating liabilities among partners for determining the tax basis of a partner’s partnership interest are set forth in Treasury Regulations promulgated under I.R.C. § 752.

economy risk of loss.\textsuperscript{800} A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner or related person would be obligated to make a payment to any person (or a contribution to the partnership) because that liability becomes due and payable and the partner or related person would not be entitled to reimbursement from another partner or person that is a related person to another partner.\textsuperscript{801} These following events are treated as occurring simultaneously:

- All of the partnership’s liabilities become payable in full;
- With the exception of property contributed to secure a partnership liability, all of the partnership’s assets (including cash) have a value of zero;
- The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership);
- All items of income, gain, loss, or deduction are allocated among the partners; and
- The partnership liquidates.\textsuperscript{802}

Nonrecourse liabilities are liabilities with respect to which no partner or partner affiliate bears the ultimate risk of loss.\textsuperscript{803} Nonrecourse liabilities are shared by partners in accordance with a three-tier sharing scheme:

- First, nonrecourse liabilities are allocated to a partner equal to the partner’s share of partnership minimum gain.
- Second, a partner has a share of nonrecourse liabilities equal to the amount of any taxable gain that would be allocated to the partner under the tax rules concerning contributed property with a “book”-tax disparity (Section 704(c)) (or in the same manner as Section 704(c) in connection with a revaluation of partnership property) if the partnership disposed of (in a taxable transaction) all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration.

\textsuperscript{800} Treas. Reg. § 1.752-2(a).
\textsuperscript{801} Treas. Reg. § 1.752-2(b)(1).
\textsuperscript{802} Id.
\textsuperscript{803} Treas. Reg. §§ 1.752-1(a)(2), 1.752-3.
• Any remaining partnership nonrecourse liabilities (“excess nonrecourse liabilities”) are allocated as determined in accordance with the partner’s share of partnership profits. The partner’s interest in partnership profits is determined by considering all facts and circumstances relating to the economic arrangement of the partners. The partnership agreement may specify the partners’ interests in partnership profits for purposes of allocating excess nonrecourse liabilities if the specified interests are reasonably consistent with allocations (that have substantial economic effect) of some other significant item of partnership income or gain. Excess nonrecourse liabilities also may be allocated among partners in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. The partnership may first allocate an excess nonrecourse liability to a partner up to the amount of built-in gain that is allocable to the partner on Section 704(c) property or property for which reverse Section 704(c) allocations are applicable (resulting from a revaluation of partnership assets) where the property is subject to the nonrecourse liability to the extent that the built-in gain exceeds the gain described in the immediately prior paragraph with respect to the property. Excess nonrecourse liabilities are not required to be allocated under the same method each year.

**c. Promissory Notes.**

While capital accounts are generally credited with the fair market value of contributed property, contributed promissory notes are generally ignored in maintaining capital accounts. A promissory note contributed to a partnership by a partner who is the maker of the promissory note will increase the partner’s capital account only when the partnership makes a taxable disposition of the promissory note or when the partner makes principal payments on the promissory note.

---

804 “Reverse Section 704(c) allocations” are allocations of tax items made in accordance with principles of I.R.C. § 704(c)(1)(A) where the partnership has revalued assets.

805 Treas. Reg. § 1.752-3(a).


Note. The rules for contribution of promissory notes are drafted as if the contribution of the promissory note is ignored.


(footnote continued on the next page)
Promissory notes readily tradable on an established securities market are an exception. These readily tradable promissory notes are credited to capital account at fair market value. 810 Few partnerships are confronted with readily tradable promissory notes contributed to their capital by the maker.

The partnership may distribute to a partner a promissory note of which the partnership is the maker. The partner’s capital account is decreased when the partner makes a taxable disposition of the note or when the partnership makes principal payments on the note. The rules work as if the promissory note distribution transaction itself is ignored. This rule does not apply if the note is readily tradable on an established securities market. Payments on most promissory notes are treated as partnership distributions.

The capital account of a partner whose interest in a partnership is liquidated is reduced to the extent of –

- The fair market value (measured at the time of distribution) of any negotiable promissory note (of which the partnership is the maker) that the partnership distributes to the partner on or after the date the partner’s interest is liquidated and within the time specified in Treasury Regulations Section 1.704-1(b)(2)(ii)(b)(2), and
- The fair market value (measured at the time of liquidation) of the unsatisfied portion of any negotiable promissory note (of which the partnership is the maker) that the partnership previously distributed to the partner.

The fair market value of a note, for this purpose, is no less than the outstanding principal balance of the note, if the note bears interest at a rate no less than the applicable federal rate at time of valuation.

Some doubt in the treatment of promissory notes is created by the rules concerning marketable securities. 811 The distribution of a marketable security generally is treated as a distribution of money. 812 (An exception exists for certain investment partnerships to eligible partners. 813) Two inclusions in the definition of “marketable security” are particularly relevant for this purpose. Marketable security includes “any financial instrument which, under its terms or any other arrangement, is readily convertible into, or exchangeable for, money or marketable

---

810 Id.
811 I.R.C. § 731(c).
812 Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

securities” and “any financial instrument the value of which is determined sub-
stantially by reference to marketable securities.”

d. Revaluation of Partnership Assets.

i) General Requirements.

Treasury Regulations permit the partnership to revalue its assets and to
credit unrealized appreciation or depreciation to capital accounts upon listed
events. The partnership is permitted to revalue its assets only upon these listed
events. Close inspection of Treasury Regulations concerning revaluations reveals
that these Treasury Regulations are not clear.

Revaluation of partnership assets on permitted events can help to preserve
partnership economics. Revaluation can provide increased capacity to make allo-
cations of recourse deductions to a partner.

Consider intangible assets (for example, goodwill) when the partnership
revalues assets. Treasury Regulations require that:

• The adjustments are based on the fair market value of partnership
property. (with a limitation that property is treated as having a

---

814 I.R.C. § 731(c)(2)(ii), (iii).
815 The revaluation rules do not technically say that assets will be revalued to
fair market value, but merely that “[t]he adjustments are based on the fair market
value of partnership property (taking section 7701(g) into account) on the date of

We know that there is at least one departure from traditional concepts of fair
market value that is mandated: property is treated as having a fair market value
equal to secured nonrecourse liabilities if the property is security for the nonr-
course liabilities and there are nonrecourse liabilities over conventional fair mar-
ket value. It nevertheless is unresolved whether other departures from a willing-
seller-willing-buyer standard are permitted. The common formulation that permits
a general partner or manager to determine the value of assets may not necessarily
work. Treasury Regulations prescribe this standard of fair market value:

For purposes of this paragraph (b)(2)(iv), the fair market value as-
signed to property contributed to a partnership, property distributed by a
partnership, or property otherwise revalued by a partnership, will be re-
garded as correct, provided that (1) such value is reasonably agreed to
among the partners in arm’s-length negotiations, and (2) the partners
have sufficiently adverse interests. If, however, these conditions are not
satisfied and the value assigned to such property is overstated or under-
(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

fair market value no less than the amount of nonrecourse liabilities
secured by the property – that is, taking Section 7701(g) (“For pur-
poses of subtitle A, in determining the amount of gain or loss (or
deemed gain or loss) with respect to any property, the fair market
value of the property shall be treated as being not less than the
amount of any nonrecourse indebtedness to which the property is
subject”) into account) on the date of adjustment.  

- The adjustments reflect the manner in which the unrealized in-
come, gain, loss, or deduction inherent in the property (that has not
been reflected in the capital accounts previously) would be allocat-
ed among the partners if the partnership made a taxable disposition
of the property for the fair market value on that date.

- Your partnership agreement requires that the partners’ capital ac-
counts be adjusted in accordance with Treasury Regulations Sec-
tion 1.704-1(b)(2)(iv)(g) for allocations to them of depreciation,
depletion, amortization, and gain or loss, as computed for “book”
purposes, with respect to the property.

- Your partnership agreement requires that the partners’ distributive
shares of depreciation, depletion, amortization, and gain or loss, as
computed for tax purposes, with respect to the property be deter-
mined so as to take account of the variation between the adjusted
tax basis and “book” value of the property in the same manner as

stated (by more than an insignificant amount), the capital accounts of the
partners will not be considered to be determined and maintained in ac-
cordance with the rules of this paragraph (b)(2)(iv). Valuation of property
contributed to the partnership, distributed by the partnership, or otherwise
revalued by the partnership shall be on a property-by-property basis, ex-
cept to the extent the regulations under section 704(c) permit otherwise.
Treas. Reg. § 1.704-1(b)(2)(iv)(h). The determination of fair market value under
many partnership agreements will not be entitled to a presumption of correctness.
Query: when should the partnership seek appraisals in determining the fair market
value of partnership assets in the case of a permitted revaluation?

Treasury Regulations are ambiguous concerning the permitted date of ad-
justment. This might be a date of a distribution to a partner, but it possibly could
be an agreed date used as a matter of convenience. The adjustment must be made
“in connection with” specified events, but Treasury Regulations do not unambigu-
ously identify the permitted date of adjustment.

As discussed below, precisely what this means is unresolved.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

under the tax rules for allocating gain or loss associated with a
“book”-tax disparity (Section 704(c)), and

- The adjustments are made principally for a substantial non-tax business purpose—
  - In connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership.
  - In connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership,
  - In connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by an existing partner acting in a partner capacity, or by a new partner acting in a partner capacity or in anticipation of being a partner, or

---

818 Query: what is a de minimis amount? Does this mean de minimis by comparison to the activity of the partnership or de minimis in the abstract? How is this rule applied to a partnership that deals only in de minimis amounts?

819 The Treasury Regulations state: “[i]n connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership” and not merely that the distribution is “[i]n connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner.” Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(ii) This language may suggest that a pro rata distribution to all partners is not an event that permits a revaluation. The pro rata distribution may not be “as consideration for an interest in the partnership.”

820 This is a new provision that relates to service partners. It applies to the grant of both capital and profits interests in the partnership. This provision presumably should apply to a restricted partnership interest where the service partner has made a Section 83(b) election, but it should not otherwise apply to a restricted partnership interest in the absence of either a Section 83(b) election or substantial vesting of the interest.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Under generally accepted industry accounting practices, if substantially all of the partnership’s property (excluding money) consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. (This is a special rule for securities partnerships.)

ii) When Can You Revalue Capital Accounts?

The partnership is not generally permitted to readjust capital accounts on the sale or exchange of a partnership interest (unless the partnership terminates for tax purposes).

The courts have not examined the meaning of “a substantial non-tax business purpose” in this context. A readjustment made solely to increase a partner’s capacity to deduct losses would not seem to satisfy this “substantial non-tax business purpose.”

Partnership case law, statutory law and administrative law do not tell us what it means to adjust capital accounts in connection with a contribution of money or other property (other than a de minimis amount) to the partnership by a new or existing partner as consideration for an interest in the partnership. One issue is: what is a de minimis amount? Another issue is: can the partners revalue capital accounts on a material contribution when the contribution is pro rata to percentage interests in the partnership? Treasury Regulations do not clarify what is a de minimis contribution or distribution of money or whether these concepts are relative to the size of the partnership or in some way are absolute. Treasury Regulations are not clear on whether the contribution of money can be an installment contribution from a partner agreed to at an earlier time. If so, when is the adjustment made? Similarly, Treasury Regulations do not clarify whether the contribution or distribution must adjust percentage interests or similarly adjust the economics of the partnership in order to permit a revaluation of partnership assets. The standard would not be particularly restrictive if any distribution permitted a revaluation of partnership assets. The pro rata distribution may not be “as consid-

---

821 Treas. Reg. § 1.704-1(b)(2)(iv)(f). Real estate or other investments by many hedge funds or other investment partnerships may disqualify them from using this rule. They will not satisfy the requirement that substantially all of the partnership’s property (excluding money) consist of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market. The term “substantially all” can be one of the most mercurial terms in tax law.
ereation for an interest in the partnership.” A liquidating distribution, even if pro rata, does permit a revaluation.

Similar ambiguities exist in revaluing capital accounts on distributions under the provision that permits the partnership to revalue capital accounts in connection with the liquidation of the partnership or a distribution of money or other property (other than a de minimis amount) by the partnership to a retiring or continuing partner as consideration for an interest in the partnership. One issue is: what is a de minimis amount? Another issue is: can the partners revalue capital accounts on a material distribution when the distribution is pro rata to percentage interests in the partnership? Another is: at precisely what instant are capital accounts revalued? Another is: precisely what does it mean for a distribution to be “consideration for an interest in the partnership.”

Capital accounts apparently can be revalued on the liquidation of the partnership. This rule applies regardless of whether this liquidation results in a de minimis amount distributed to a partner. A court, however, might read Treasury Regulations differently.

When the partnership revalues capital accounts in connection with the distribution or the liquidation is not unambiguously clear. When the partnership revalues capital accounts in the face of serial operating distributions or serial distributions in liquidation of the partnership or a partner is not unambiguously clear. Whatever the case, once the date of adjustment is identified, “[t]he adjustments [must be] based on the fair market value of partnership property (taking section 7701(g) into account) on the date of adjustment.”

The failure of Treasury Regulations robustly to address installment distributions creates issues concerning distributions in installments. A partnership might declare a distribution to Partner X and might agree to make that distribution in four installments. Does the Treasury Regulation permit the partnership to revalue capital accounts based on the information available at the time this agreement is adopted by the partnership? Is the revaluation made on the first distribution? Does it matter whether an individual installment is a de minimis amount? Should the revaluation be based on values at the time of the first distribution? Can the partnership revalue capital accounts on each distribution if there is a series of agreed distributions? Can the revaluation occur on an agreed date (perhaps the first of the month) that is not the date of the distribution (but with the revaluation still in connection with the liquidation of the partnership or a distribution of money or other property [other than a de minimis amount] by the partnership to a retiring or continuing partner as consideration for an interest in the partnership)?

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The XYZ partnership agrees to retire Partner Y’s interest in the XYZ by distributing to Partner Y a promissory note providing for monthly payments payable over its 10-year term. When is XYZ permitted to revalue its assets? Can XYZ revalue its assets at the time of approving the redemption? Can XYZ revalue its assets when it distributes its promissory note to Partner Y? Can XYZ revalue its assets on its first note payment? Can XYZ revalue its assets on each promissory note payment? Would it make a difference if the promissory note were payable annually? Treasury Regulations provide poor guidance on these issues. Similarly, few partnership agreements do a good job of setting forth the rights of the parties with respect to these issues.

iii) Revaluation on Admission of a Service Partner.

Treasury Regulations permit revaluation of partnership assets in connection with the grant of an interest in the partnership (other than a de minimis interest) as consideration for the provision of services. This rule applies only if the partnership interest is granted on or after May 6, 2004. No adjustment to capital accounts appears to be permitted with respect to the transfer of a partnership interest as consideration for services before May 6, 2004. This distinction can complicate partnership accounting. On the admission of a service partner, see, for example, Cowan, “Receipt of an Interest in Partnership Profits: The Diamond Case,” 26 TAX L. REV. 161 (1972); “Prop. Regs. on Partnership Equity for Services: The Collision of Section 83 and Subchapter K,” 103 JOURNAL OF TAXATION 69, 78-80 (2005); Richard Lipton, “Proposed Regs, Rev. Proc. on Transfers of Partnership Equity Interests for Services: Did the IRS Get It Right?,” 109 TAX NOTES 791, 808-10 (2005); New York State Bar Association Tax Section, “Report On The Proposed Regulations And Revenue Procedure Relating To Partnership Equity Transferred In Connection With The Performance Of Services,” 2005 TNT 214-19 (October 26, 2005); David P. Hariton, “NYSBA Tax Section Comments on Proposed Regs on Exchanges of Partnership Interests for Services,” 109 TAX NOTES 1312, 1336-37 (2005); Los Angeles County Bar Association Taxation Section Pass-Through Entities Committee, “Comments On Proposed Partnership Equity Compensation Regulations,” 2006 TNT 133-56 (Jun. 19, 2006); Karen C. Burke, “Taxing Compensatory Partnership Options,” Tax Notes, Sept. 22, 2003, p. 1569 at 1577-1578; Martin J. McMahon Jr., “Recognition of Gain by a P'Ship Issuing an Equity Interest for Services: the Proposed Regulations Get It Wrong,” 109 TAX NOTES 1161 (Nov. 28, 2005); Frederic Nicholson, “Interest in Partnership Capital Received in Exchange for Services,” 19 N.Y.U. FEDERAL INSTITUTE ON TAXATION (footnote continued on the next page)
Partnerships can revalue capital accounts in connection with the grant of an interest in the partnership (other than a de minimis interest) on or after May 6, 2004, as consideration for the provision of services to or for the benefit of the partnership by –

- An existing partner acting in a partner capacity, or
- A new partner acting in a partner capacity or in anticipation of being a partner.

Partnerships were not permitted to revalue capital accounts in connection with the grant of an interest for services before May 6, 2004. The partnership failed to maintain its capital accounts in accordance with the Treasury Regulations on capital account maintenance if the partnership revalued capital accounts in connection with the grant of an interest for services before May 6, 2004. 825


Consider the anomalies that can be created where the fair market value of a partnership interest differs from an interest share of the net value of partnership assets associated with that partnership interest. Consider the anomalies that result when a partner is admitted with a capital interest that may differ from the fair market value of the partnership interest on account of discounts or premiums. Also, see discussion in text accompanying note 688 and materials discussed in notes 823 and 693.

The preamble to the proposed regulations provides:

Section 83 generally applies to a transfer of property by one person to another in connection with the performance of services. The courts have held that a partnership capital interest is property for this purpose. See Schulman v. Commissioner, 93 T.C. 623 (1989) (section 83 governs the issuance of an option to acquire a partnership interest as compensation for services provided as an employee); Kenroy, Inc. v. Commissioner, T.C. Memo 1984-232. Therefore, the proposed regulations provide that a partnership interest is property within the meaning of section 83, and that the transfer of a partnership interest in connection with the performance of services is subject to section 83.

The proposed regulations apply section 83 to all partnership interests, without distinguishing between partnership capital interests and partnership profits interests. Although the application of section 83 to partnership profits interests has been the subject of controversy, see, for example, Campbell v. Commissioner, T.C. Memo 1990-162, aff’d in part and rev’d (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

in part, 943 F.2d 815 (8th Cir. 1991), n. 7; St. John v. U.S., 84-1 USTC 9158 (C.D. Ill. 1983), the Treasury Department and the IRS do not believe that there is a substantial basis for distinguishing among partnership interests for purposes of section 83. All partnership interests constitute personal property under state law and give the holder the right to share in future earnings from partnership capital and labor. Moreover, some commentators have suggested that the same tax rules should apply to both partnership profits interests and partnership capital interests. These commentators have suggested that taxpayers may exploit any differences in the tax treatment of partnership profits interests and partnership capital interests. The Treasury Department and the IRS agree with these comments. Therefore, all of the rules in these proposed regulations and the accompanying proposed revenue procedure (described below) apply equally to partnership capital interests and partnership profits interests. However, a right to receive allocations and distributions from a partnership that is described in section 707(a)(2)(A) is not a partnership interest. In section 707(a)(2)(A), Congress directed that such an arrangement should be characterized according to its substance, that is, as a disguised payment of compensation to the service provider. See S. Rep. No. 98-169, 98 Cong. 2d Sess., at 226 (1984).

Section 83(b) allows a person who receives substantially nonvested property in connection with the performance of services to elect to include in gross income the difference between: (A) the fair market value of the property at the time of transfer (determined without regard to a restriction other than a restriction which by its terms will never lapse); and (B) the amount paid for such property. Under section 83(b)(2), the election under section 83(b) must be made within 30 days of the date of the transfer of the property to the service provider.

Consistent with the principles of section 83, the proposed regulations provide that, if a partnership interest is transferred in connection with the performance of services, and if an election under section 83(b) is not made, then the holder of the partnership interest is not treated as a partner until the interest becomes substantially vested. If a section 83(b) election is made with respect to such an interest, the service provider will be treated as a partner for purposes of Subtitle A of the Code. These rules are similar to the current rules pertaining to substantially nonvested stock in a subchapter S corporation. See § 1.1361-1(b)(3) (upon an election under section 83(b), the service provider becomes a shareholder for purposes of subchapter S).

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The revaluation in connection with the grant of an interest in the partnership for services must be in connection with the grant of an interest that is not de minimis. The Treasury Regulations do not provide guidance concerning when an interest in the partnership is de minimis. They do not provide guidance concerning whether de minimis is based on the percentage size of the interest or on the fair

These principles differ from Rev. Proc. 2001-43. Under that revenue procedure, if a partnership profits interest is transferred in connection with the performance of services, then the holder of the partnership interest may be treated as a partner even if no section 83(b) election is made, provided that certain conditions are met.

Certain changes to the regulations under both subchapter K and section 83 are needed to coordinate the principles of subchapter K with the principles of section 83. Among the changes that are proposed in these regulations are: (1) conforming the subchapter K rules to the section 83 timing rules; (2) revising the section 704(b) regulations to take into account the fact that allocations with respect to an unvested interest may be forfeited; and (3) providing that a partnership generally recognizes no gain or loss on the transfer of an interest in the partnership in connection with the performance of services for that partnership. In addition, Rev. Proc. 93-27 (1993-2 C.B. 343), and 2001-43 (2001-2 C.B. 191), which generally provide for nonrecognition by both the partnership and the service provider on the transfer of a profits interest in the partnership for services performed for that partnership, must be modified to be consistent with these proposed regulations. Accordingly, in conjunction with these proposed regulations, the IRS is issuing Notice 2005-43 (2005-24 I.R.B.). That Notice contains a proposed revenue procedure that, when finalized, will obsolete Rev. Proc. 93-27 and 2001-43. The Treasury Department and the IRS intend for these proposed regulations and the proposed revenue procedure to become effective at the same time. The proposed amendments to the regulations under section 83 and subchapter K, as well as the Notice, are described in further detail below.

The proposed revenue procedure and certain parts of the proposed regulations (as described below) only apply to a transfer by a partnership of an interest in that partnership in connection with the performance of services for that partnership (compensatory partnership interests). The Treasury Department and the IRS request comments on the income tax consequences of transactions involving related persons, such as, for example, the transfer of an interest in a lower-tier partnership in exchange for services provided to the upper-tier partnership.

REG-105346-03; 70 F.R. 29675-29683 (May 24, 2005).
market value of the interest. One might infer that perhaps an interest in *de minimis* if the interest was granted only in order to permit a revaluation of partnership assets. Whether this inference is correct is not clear.

The revaluation requires that services be provided to the partnership or for the benefit of the partnership. Services provided for a partner but not for the benefit of the partnership apparently do not qualify to permit a revaluation. Services performed for a third party on behalf of the partnership should qualify to permit a revaluation.

The optional adjustment to capital account on account of the admission of a service partner may be made (but is not required to be made) if the partnership interest is transferred –

- As consideration for the provision of services to the partnership by an existing partner acting in a partner capacity, or
- As consideration for the provision of services for the benefit of the partnership by an existing partner acting in a partner capacity, or
- As consideration for the provision of services to the partnership by a new partner acting in a partner capacity or in anticipation of being a partner, or
- As consideration for the provision of services for the benefit of the partnership by a new partner acting in a partner capacity or in anticipation of being a partner.  

This provision (concerning revaluation of assets upon the grant of interests transferred to a service partner) corresponds to the revised position of the IRS that the grant of a profits interest to a service partner potentially is taxable to the service partner.  

Treasury Regulations do not clarify precisely when these adjustments are made. Furthermore, adjustments might be permissible when the interest of a service partner is increased on account of the performance of services. This is a new provision. No one is certain how it will be interpreted by the courts.

---

827 Cf. Prop. Treas. Reg. § 1.83-3(e) (“Accordingly, property includes a partnership interest. The previous sentence is effective for transfers on or after the date final regulations are published in the Federal Register.”).
iv) How is Revaluation Surplus or Loss Allocated?

The adjustments to capital accounts must “reflect the manner in which the unrealized income, gain, loss, or deduction inherent in such property (that has not been reflected in the capital accounts previously) would be allocated among the partners if there were a taxable disposition of such property for such fair market value on that date.”

This language does not completely instruct us how to allocate the adjustment. Treasury Regulations are not effective in explaining how revaluation surplus is allocated among the partners. The allocation of revaluation surplus or revaluation loss can appear simple when the partnership has a partnership agreement with allocations based on straight percentage interests for all items. The allocation of revaluation surplus or revaluation loss is considerably less certain when the partnership agreement contains tiered allocations, preferred returns, triggers based on internal rates of return, etc. The allocation of revaluation surplus or revaluation loss is considerably less certain when the partnership agreement applies the varying interests rule based on a temporal proration method. The discussion in this section is almost wholly speculative – and it perhaps could turn out to be completely wrong.

Treasury Regulations do not clarify how revaluations work with realized income and loss items. Allocate revaluation adjustments as if they were gain from sale of partnership property for purpose of allocations.

Revaluations do not occur in the abstract. They often are accompanied by changes in partnership interests that require the use of the varying interests rule. Whether revaluation adjustments are made only when changes are made in partnership interests, is unresolved. The varying interests rule of Section 706 perhaps should be important in allocating revaluation adjustments. Treasury Regulations concerning revaluation adjustments, however, are not sufficiently detailed to provide adequate guidance.

---

829 One partner could agree to make capital contributions in material installments. *Query*: will this permit a revaluation on the payment of each installment?
830 Section 706(d)(1) provides that:

*Except as provided in paragraphs (2) [Certain cash basis items prorated over period to which attributable] and (3) [Items attributable to interest in lower tier partnership prorated over entire taxable year], if during any taxable year of the partnership there is a change in any partner’s interest in the partnership, each partner’s distributive share of any item of income, gain, loss, deduction, or credit of the partnership for such taxable year shall be determined by the use of any method prescribed by the Sec* (footnote continued on the next page)
A partnership agreement may allocate all partnership items in accordance with simple percentage interests. The partnership has these tax items during the partnership’s taxable year:

retary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

I.R.C. § 706(d)(1).

Treasury Regulations provide:

If a partner sells or exchanges a part of his interest in a partnership, or if the interest of a partner is reduced, the partnership taxable year shall continue to its normal end. In such case, the partner’s distributive share of items which he is required to include in his taxable income under the provisions of section 702(a) shall be determined by taking into account his varying interests in the partnership during the partnership taxable year in which such sale, exchange, or reduction of interest occurred.

Treas. Reg. § 1.706-1(c)(4).

Treasury Regulations provide:

(ii) Inclusions in taxable income. In the case of a sale, exchange, or liquidation of a partner’s entire interest in a partnership, the partner shall include in his taxable income for his taxable year within or with which his membership in the partnership ends, his distributive share of items described in section 702(a), and any guaranteed payments under section 707(c), for his partnership taxable year ending with the date of such sale, exchange, or liquidation. In order to avoid an interim closing of the partnership books, such partner’s distributive share of items described in section 702(a) may, by agreement among the partners, be estimated by taking his pro rata part of the amount of such items he would have included in his taxable income had he remained a partner until the end of the partnership taxable year. The proration may be based on the portion of the taxable year that has elapsed prior to the sale, exchange, or liquidation, or may be determined under any other method that is reasonable. Any partner who is the transferee of such partner’s interest shall include in his taxable income, as his distributive share of items described in section 702(a) with respect to the acquired interest, the pro rata part (determined by the method used by the transferor partner) of the amount of such items he would have included had he been a partner from the beginning of the taxable year of the partnership.

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Revaluation Gain $1,100,000
Income Items from Operations $120,000
Loss Items from Operations $100,000

Assume that the revaluation was made on a capital contribution by one of the partners. The capital contribution occurred on July 1, midway through the taxable year. These are percentage interests before and after the contribution:

<table>
<thead>
<tr>
<th>Net Profits and Net Losses Percentage Before Contribution</th>
<th>Net Profits and Net Losses Percentage After Contribution</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner X</td>
<td>50.0000%</td>
</tr>
<tr>
<td>Partner Y</td>
<td>50.0000%</td>
</tr>
<tr>
<td>Partner Z</td>
<td>0.0000%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0000%</td>
</tr>
</tbody>
</table>

The partnership might apply the varying interests rule by using the closing the books method. This is the simpler method for allocating the revaluation surplus. Using the varying interests rule, allocate the revaluation 50% to Partner X and 50% to Partner Y. Closing the partnership books allocates all of the revaluation surplus to the continuing partners (in accordance with their pre-change percentages). This is the simpler method.

The language of Treasury Regulations admits the interpretation that we should consider other partnership items recognized through the date of the event permitting the revaluation, in allocating the revaluation surplus. Considering other recognized items in allocating revaluation surplus (or not considering other recognized items in allocating revaluation surplus) could be important when the partnership has preferred returns, internal rate of return tiers, or otherwise allocates partnership items by tiers. There could be a large allocation of revaluation surplus, in appropriate circumstances, to a partner (perhaps as a preferred return) who, but for the revaluation, would receive a large allocation of current ordinary income. The revaluation may substitute a nontaxable revaluation surplus allocation for what otherwise would be a current ordinary income allocation to a partner. Allocating revaluation surplus to satisfy a preferred return can have both deferral and conversion effects. Advisors might engineer serial revaluations in appropriate circumstances in order to accomplish abusive planning. Much of a preferred return, for example, might be converted to an allocation of revaluation surplus. A partner with a preferential allocation measured by an internal rate of return might receive a substantial allocation of revaluation surplus in substitute for a large allocation of ordinary income that the partner otherwise might receive.

The partnership might seek to apply the varying interests rule by prorating items between the period before the revaluation adjustment and the period after
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

the revaluation adjustment. This allocation determines a varying interests percentage for each partner. It allocates partnership items based on that percentage. This methodology applies regardless of whether the partnership item is recognized before the change or after the change. The varying interests rule might be applied using a month-by-month convention. The change in interests occurs one-half way through the year. This shows the adjusted net profits ratio for each of the partners:

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner X</td>
<td>50.0000%</td>
<td>25.0000%</td>
<td>33.3333%</td>
<td>16.6667%</td>
<td>41.6667%</td>
</tr>
<tr>
<td>Partner Y</td>
<td>50.0000%</td>
<td>25.0000%</td>
<td>33.3333%</td>
<td>16.6667%</td>
<td>41.6667%</td>
</tr>
<tr>
<td>Partner Z</td>
<td>0.0000%</td>
<td>0.0000%</td>
<td>33.3333%</td>
<td>16.6667%</td>
<td>16.6667%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
<td>100.0000%</td>
</tr>
</tbody>
</table>

The partnership computes Net Profits or Net Losses for the taxable year by including all items (apparently including the revaluation surplus as an item of gain). The allocation factor in the final column is used to determine each partner’s allocation of Net Profits or Net Losses. This suggests that Partner X will have a 41.6667% share of the net number. Partner Y will have a 41.6667% share of the net number. Partner Z will have a 16.6667% share of the net number. Furthermore, this suggests that Partner X will have a 41.6667% share of the revaluation surplus. Partner Y will have a 41.6667% share of the revaluation surplus. Partner Z will have a 16.6667% share of the revaluation surplus. This is the possible result:

<table>
<thead>
<tr>
<th></th>
<th>Allocation Factor for Net Profits and Net Losses Combining Before and After Change</th>
<th>Allocation of $1,100,000 Revaluation Surplus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner X</td>
<td>41.6667%</td>
<td>$458,333</td>
</tr>
<tr>
<td>Partner Y</td>
<td>41.6667%</td>
<td>$458,333</td>
</tr>
<tr>
<td>Partner Z</td>
<td>16.6667%</td>
<td>$183,333</td>
</tr>
<tr>
<td>Total</td>
<td>100.0000%</td>
<td>$1,100,000</td>
</tr>
</tbody>
</table>

777
Whether Partner Z, the new partner, is permitted by the tax law to receive a share of the revaluation surplus is unresolved. As a matter of policy, revaluation surplus perhaps should be allocated exclusively to the continuing partners and not to the new partner whose contribution caused the revaluation. The Treasury Regulations do not contain an explicit prohibition of the new partner receiving a share of the revaluation surplus contained in.

Treasury Regulations provide a methodology for allocating revaluation surplus that is clear only in the simplest situation. The rules in Treasury Regulations are not easily extended to more complicated situations. This area of Treasury Regulations would benefit from reevaluation by the Treasury. Treasury Regulations do not provide particularly clear or adequate guidance concerning allocating revaluation surplus and revaluation loss, except in the simplest situation. The allocation method conceivably could result in shifting tax benefits to one partner and shifting tax detriments to other partners. The allocation method might result in the new partner receiving a share of the revaluation surplus.

v) Drafting Allocations after Capital Account Revaluations.

Many partnership agreements treat revaluation adjustments as items of income and loss to be allocated along with other partnership items. Much is to be said for this approach. This approach accords with the general scheme of Treasury Regulations concerning capital account maintenance. This approach often makes it easier to draft allocations to take into account revaluation gain or loss that already has been reflected in capital accounts.

Many partnership agreements permit revaluations of capital accounts, but they do not take these revaluations into account in adjusting allocations. For example, a partnership agreement may provide for a first tier allocation of Net Profits to charge back prior allocations or Net Losses or a second tier allocation that corresponds with a preferred returns. Revaluation surplus may be allocated on a revaluation event to fill this chargeback and preferred allocation. Be careful in drafting allocations after a revaluation to ensure that your partnership agreement not provide for a double allocation – first charging back losses and revaluation surplus and then allocating Net Profits to charge back the losses a second time. Similarly, be careful that your partnership agreement not allocate both revaluation surplus to satisfy a preferred allocation and then allocate Net Profits to satisfy the same preferred allocation.

831 See discussion in text accompanying note 815.
vi) Noncompensatory Partnership Options.

The IRS has proposed (but at the time when this Article is written has not finalized) Treasury Regulations concerning the income tax consequences of issuing, transferring, and exercising noncompensatory options to acquire a partnership interest. These Proposed Treasury Regulations are important. They affect capital accounting, revaluations and partnership allocations. The Proposed Treasury Regulations provide insight into when the holder of a noncompensatory option to acquire a partnership interest may be treated as a tax partner. The Proposed Treasury Regulations apply only if a call option, warrant, or conversion right entitles the holder to the right to acquire an interest in the issuer partnership (or to cash or property having a value equal to the value of such an interest). Partnership options are important to consider when drafting your partnership agreement if you are drafting a partnership agreement for a partnership with outstanding noncompensatory options to acquire a partnership interest. Bear in mind in mind at least a general idea of how noncompensatory partnership options are taxed if you are drafting a partnership agreement for a partnership issuer of a noncompensatory option. Many uncertainties concerning the tax effects of noncompensatory partnership options linger pending the finalization of the Proposed Treasury Regulations on noncompensatory options to acquire a partnership interest. Partnership noncompensatory options to acquire a partnership interest provide especially thorny drafting issues pending the finalization of the Proposed Treasury Regulations on account of the current uncertainty of the law surrounding noncompensatory options to acquire a partnership interest. In reviewing the details of the Proposed Treasury Regulations, consider what may be the current law pending the finalization of the Proposed Treasury Regulations.

The Proposed Treasury Regulations on noncompensatory partnership options provide that the exercise of a noncompensatory option generally does not cause recognition of gain or loss to either the issuing partnership or the option holder. Similarly, the issuance of a noncompensatory option in exchange for a contribution of property is not a nonrecognition transaction. The issuance of a noncompensatory call option or warrant is generally an open transaction for the issuer. The issuing partnership’s income or loss from the noncompensatory option does not become fixed and determinable until the lapse, exercise, repurchase, or other termination of the option. The holder’s purchase of the option is merely an investment in the option. This purchase is merely a nondeductible capital expendi-

---

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

ture. The purchaser of a partnership option will recognize gain or loss (and the partnership will have a cost tax basis) if the purchaser transfers appreciated or depreciated property to the partnership as consideration for the option. The transfer of property for an option is not treated as a nontaxable capital contribution.

The issuance of a partnership interest to the holder of a noncompensatory option is not taxable to the holder or the issuing partnership. Nonrecognition applies to the holder and the issuing partnership upon the exercise of a noncompensatory option issued by the issuing partnership. For capital accounting purposes, the holder is treated as exchanging the option fee and exercise price as a capital contribution to the issuing partnership. The lapse of a noncompensatory option results in the recognition of income by the issuing partnership and the recognition of loss by the former option holder.

When the holder exercises an option, the holder receives a partnership interest with a value that is greater or less than the aggregate value of the premium and exercise price that the option holder contributes to the issuing partnership. The Proposed Treasury Regulations generally allow partnerships to substitute built-in gain or loss in the issuing partnership’s assets for the built-in gain or loss in the option. The Proposed Treasury Regulations provide that, after exercise of the option, a noncompensatory option holder’s initial capital account is equal to the sum of (i) the consideration paid to the issuing partnership to acquire the noncompensatory option and (ii) the fair market value of any property (other than the option) contributed to the issuing partnership on the exercise of the noncompensatory option. The capital account of the exercising holders is not credited with the fair market value of the option privilege. The issuing partnership must revalue its assets immediately following the exercise of the noncompensatory option. The issuing partnership must allocate the revaluation surplus or revaluation loss from the unrealized income, gain, loss, and deduction from this revaluation: first, to the noncompensatory option holder, to the extent necessary to reflect the holder’s right to share in partnership capital under the issuing partnership agreement, and, then, to the historic partners, to reflect the manner in which the unrealized income, gain, loss, or deduction in the partnership property would be allocated among those partners if there were a taxable disposition of this property for its fair market value on that date of admission of the option holder as a partner. This allocation will create potential gain or loss that will be allocated under the principles of Section 704(c)(1)(A).833

833 The Proposed Treasury Regulations more precisely provide: “The fair market value of partnership property must be adjusted to account for any outstanding noncompensatory options (as defined in §1.721- 2(d)) at the time of a revaluation of partnership property under paragraph (b)(2)(iv)( ) or (s) of this sec-
(footnote continued on the next page)
The built-in gain or loss in the option may exceed the unrealized appreciation or depreciation in the issuing partnership’s assets (that has not been reflected in the partners’ capital accounts previously). This can make it impossible merely to correct the exercising option holder’s capital account by allocating to the option holder revaluation surplus or revaluation loss. The Proposed Treasury Regulations require that the issuing partnership make corrective allocations of gross income or loss to the partners in the year in which the noncompensatory option is exercised so as to consider any shift in the partners’ capital accounts that occurs as a result of the exercise of a noncompensatory option. Corrective allocations are allocations of gross tax items that differ from the issuing partnership’s allocations of “book” items. Where insufficient tax items are available in the year of exercise fully to correct the capital shift, additional corrective allocations are required in succeeding taxable years until the capital shift has been fully taken into account. 

If the fair market value of outstanding noncompensatory options (as defined in §1.721-2(d)) as of the date of the adjustment exceeds the consideration paid by the option holders to acquire the options, then the fair market value of partnership property must be reduced by that excess to the extent of the unrealized income or gain in partnership property (that has not been reflected in the capital accounts previously). This reduction is allocated only to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation. If the price paid by the option holders to acquire the outstanding noncompensatory options (as defined in §1.721-2(d)) exceeds the fair market value of such options as of the date of the adjustment, then the value of partnership property must be increased by that excess to the extent of the unrealized deduction or loss in partnership property (that has not been reflected in the capital accounts previously). This increase is allocated only to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation.” Prop. Treas. Reg. § 1.704-1(b)(2)(iv)(h)(2).

834 Prop. Treas. Reg. § 1.704-1(b)(4)(x) (“If partnership capital is reallocated between existing partners and a partner exercising a noncompensatory option under paragraph (b)(2)(iv)(s)(3) of this section (a capital account reallocation), the partnership must, beginning with the taxable year of the exercise and in all succeeding taxable years until the allocations required are fully taken into account, make corrective allocations so as to take into account the capital account reallocation. A corrective allocation is an allocation (consisting of a pro rata portion of each item) for tax purposes of gross income and gain, or gross loss and deduction, that differs from the partnership’s allocation of the corresponding book item. See Example 21 of paragraph (b)(5) of this section.”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The partnership may revalue capital accounts at a time when partnership options are outstanding. The Proposed Treasury Regulations require that any revaluation (during the period in which outstanding noncompensatory options to acquire a partnership interest are outstanding) generally must consider the fair market value (if any) of outstanding options.\(^\text{835}\)

Unexercised noncompensatory options to acquire a partnership interest create substantial economic effect issues. The impact of noncompensatory options

\(^{835}\) Prop. Treas. Reg. § 1.704-1(b)(4)(ix) ("Allocations with respect to non-compensatory options. A partnership agreement may grant to a partner that exercises a noncompensatory option a right to share in partnership capital that exceeds (or is less than) the sum of the amounts paid by the partner to acquire and exercise such option. In such a case, allocations of income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding cannot have economic effect, because, if the noncompensatory option is exercised, the exercising partner, rather than the existing partners, may receive the economic benefit or bear the economic detriment associated with that income, gain, loss, or deduction. Allocations of partnership income, gain, loss, and deduction to the partners while the noncompensatory option is outstanding will be deemed to be in accordance with the partners’ interests in the partnership only if – (a) The holder of the noncompensatory option is not treated as a partner under §1.761-3; (b) The partnership agreement requires that, on the exercise of the noncompensatory option, the partnership comply with the rules of paragraph (b)(2)(iv)(s) of this section; and (c) All material allocations and capital account adjustments under the partnership agreement not pertaining to noncompensatory options are recognized under section 704(b). See Examples 20 through 24 of paragraph (b)(5) of this section.").
to acquire a partnership interest on substantial economic effect of partnership allocations is uncertain under current law. Noncompensatory options generally do not entitle the holder to a distributive share of partnership income and loss. Noncompensatory options are generally not treated as current partnership interests until the options are exercised and the holder is admitted as a partner. When a noncompensatory option provides the holder with rights that are substantially similar to the rights afforded to a partner, the holder presumably should be treated as a partner. The option should be taken into account in allocating partnership income. The Proposed Treasury Regulations provide that a noncompensatory option to acquire a partnership interest is treated as a partnership interest and not merely as an option if the option (and any rights associated with it) provides the holder with rights that are substantially similar to the rights afforded to a partner.\footnote{Prop Treas. Reg. § 1.761-3(a).}

This rule applies only if, as of the date when the noncompensatory option is issued, transferred, or modified, a “strong likelihood” exists that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners’ and the holder’s aggregate tax liabilities. The noncompensatory option apparently can provide the holder with rights substantially similar to the rights afforded to a partner and the holder nevertheless will not be treated as a tax partner if, as of the date when the noncompensatory option is issued, transferred, or modified, a “strong likelihood” does not exist that the failure to treat the holder of the noncompensatory option as a partner would result in a substantial reduction in the present value of the partners’ and the holder’s aggregate tax liabilities.

The holder of a noncompensatory option sometime can be treated as a partner. Then, the partner’s distributive share of the partnership’s income, gain, loss, deduction or credit (or items thereof) is determined in accordance with that partner’s interest in the partnership (considering all of the relevant facts and circumstances). This can seriously disrupt your planned allocations.

Determining whether a noncompensatory option to acquire a partnership interest provides the holder with rights that are substantially similar to the rights afforded to a partner involves an “all facts and circumstances” test. This test considers, among other factors, whether the option to acquire the partnership interest is “reasonably certain” to be exercised (as of the time that the option is issued, transferred or modified) and whether the option holder possesses partner attributes. The holder of the option to acquire a partnership interest ordinarily has rights that are substantially similar to the rights afforded to a partner if the noncompensatory option is reasonably certain to be exercised.\footnote{Prop Treas. Reg. § 1.761-3(c)(1).} These factors are relevant in
determining whether a noncompensatory option is reasonably certain to be exercised (as of the time that the noncompensatory option is issued, transferred, or modified) –

- The fair market value of the partnership interest that is the subject of the option.
- The exercise price of the option.
- The term of the option.
- The volatility, or riskiness, of the partnership interest that is the subject of the option.
- The fact that the option premium and, if the option is exercised, the option exercise price, will become assets of the partnership.
- Anticipated distributions by the partnership during the term of the option.
- Any other special option features (for example, an exercise price that declines over time or declines contingent on the happening of specific events).
- The existence of related options (including reciprocal options).
- Any other arrangements (express or implied) affecting the likelihood that the option will be exercised.\(^{838}\)

The Proposed Treasury Regulations clarify that partner attributes include.

- The extent to which the holder of the option will share in the economic benefit of partnership profits (including distributed profits) and in the economic detriment associated with partnership losses.
- The existence of any arrangement (either within the option agreement or in a related agreement) that, directly or indirectly, allows the holder of a noncompensatory option to control or restrict the activities of the partnership.\(^{839}\)

Rights in the partnership possessed by the option holder solely by virtue of owning a partnership interest and not by virtue of holding a noncompensatory option are not taken into account, if those rights are no greater than rights granted to other partners owning similar interests in the partnership.\(^{840}\)

\(^{838}\) Prop Treas. Reg. § 1.761-3(c)(2).
\(^{839}\) Prop Treas. Reg. § 1.761-3(c)(2).
\(^{840}\) Prop Treas. Reg. § 1.761-3(c)(3).
vii) **Securities Partnerships.**

The provision concerning revaluation of the assets of a partnership substantially all of the property (excluding money) of which consists of stock, securities, commodities, options, warrants, futures, or similar instruments that are readily tradable on an established securities market, is limited to securities partnerships. The standard of “substantially all” in this context has not been established precisely. Securities partnerships frequently take advantage of this rule regularly to revalue their assets.

viii) **Tax Items Associated with Revalued Assets.**

Special rules apply when partnership property has been revalued to a value that differs from adjusted tax basis. These rules are based on principles of the partnership rules governing the allocation of tax items attributable to “book”-tax disparities (Section 704(c)(1)(A)). Capital accounts afterwards are adjusted by allocations of depreciation, depletion, amortization, and gain or loss, as computed for “book” purposes rather than for tax purposes.

ix) **Determination of Values for Revaluations.**

Revaluations determined by the partnership are presumed correct, if the values used in the revaluations are reasonable and satisfy several tests in Treasury Regulations. The fair market value assigned by the partnership (usually in the partnership agreement, but often in other contracts) to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, normally is presumed as correct. This presumption applies only if the agreement meets two tests:

- The value is reasonably agreed to among the partners in arm’s-length negotiations.
- The partners have sufficiently adverse interests.\(^\text{841}\)

These may be restrictive conditions. Valuations contained in partnership documents may not be presumed to be correct if these conditions are not met. The capital accounts of the partners will not be considered to be determined and maintained in accordance with the capital accounting rules in the Treasury Regulations if the two conditions are not satisfied and the value assigned to the property is overstated or understated (by more than an insignificant amount). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership is undertaken on a property-by-property basis,

---

\(^{841}\) Treas. Reg. § 1.704-1(b)(2)(iv)(h).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

except to the extent expressly permitted by Treasury Regulations. For example, this suggests the important of careful allocations among all assets (including separate allocations to land and building).  

This presumption of correctness may be much more limited than most advisors perceive. This presumption of correctness may require the partnership to document and to establish arm’s-length negotiations. This may require the partnership to prove material adversity concerning the values. Many partnership transactions may not be entitled to this presumption of correctness of agreed values. The standard for determining fair market values is particularly important with partnerships among related partners (for example, for partnerships among family members and partnerships among consolidated group members). These partnerships may not qualify for the presumption that agreed fair market values are correct. The result might put these partnerships in peril of violating the capital account maintenance rules (and, by extension, the rules of substantial economic effect) unless these partnerships can establish that the agreed fair market values that they used satisfy the willing-seller-willing-buyer standard.

Many partnership agreements treat revaluation adjustments as items of income and loss to be allocated along with other partnership items. Much is to be said for this approach. This approach accords with the general scheme of Treasury Regulations concerning capital account maintenance. This approach often makes it easier to draft allocations to take into account revaluation gain or loss that already has been reflected in capital accounts. Many partnerships permit revaluations of capital accounts, but they do not take these revaluations into account in adjusting allocations. For example, a partnership agreement may provide for a first tier allocation of Net Profits to charge back prior allocations or Net Losses or

---

842 Treas. Reg. § 1.704-1(b)(2)(iv)(h) (“For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm’s-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.”).

843 See discussion in text accompanying note 815.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

a second tier allocation that corresponds with a preferred returns. Revaluation surplus may be allocated on a revaluation event to fill this chargeback and preferred allocation. Be careful in drafting allocations after a revaluation to ensure that your partnership agreement not provide for a double allocation – first charging back losses and revaluation surplus and then allocating Net Profits to charge back the losses a second time. Similarly, be careful that your partnership agreement not allocate both revaluation surplus to satisfy a preferred allocation and then allocate Net Profits to satisfy the same preferred allocation.

e. “Book”-Tax Disparities.

“Book” depreciation with respect to property with a “book” value that differs from tax basis can be determined by starting with initial “book” value and depreciating that “book” basis in accordance with federal income tax principles. Similarly, “book” gain from sale can be determined by reference to the “book” value of the property rather than the tax basis of the property with a “book”-tax disparity. More technically, the amount of “book” depreciation, depletion, or amortization, when a “book”-tax disparity exists, for a period with respect to an item of partnership property is the amount that bears the same relationship to the “book” value of the property as –

- The depreciation (or cost recovery deduction), depletion, or amortization computed for tax purposes with respect to the property for the period bears to
- The adjusted tax basis of the property.  


845 More precisely, the applicable Treasury Regulations state:

(g) Adjustments to reflect book value.

(1) In general. Under paragraphs (b)(2)(iv)(d) and (b)(2)(iv)(f) of this section, property may be properly reflected on the books of the partnership at a book value that differs from the adjusted tax basis of such property. In these circumstances, paragraphs (b)(2)(iv)(d)(3) and (b)(2)(iv)(f)(3) of this section provide that the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv) unless the partnership agreement requires the partners’ capital accounts to be adjusted in accordance with this paragraph (b)(2)(iv)(g) for allocations to them of depreciation, depletion, amortization, and gain or loss, as computed for book purposes, with respect to such property. In determining whether the economic effect of an allocation of book items is substantial, consideration will be given to the effect of such allocation on the determination of the (footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

The “book” depreciation, depletion, or amortization of contributed property that has a zero adjusted tax basis may be determined under any reasonable method selected by the partnership. 846

133. Nonrecourse Deductions.


Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

The liabilities are otherwise discharged). This is no more than an introduction to the complicated subject of nonrecourse deductions.

The tax basis of property often has two components – basis that is attributable to nonrecourse liabilities and basis that is attributable to “something else” (recourse liabilities, cash capital contributions, basis at time of contribution of contributed assets, etc.). Tax depreciation in the common situation, first represents depreciation of “something else.” Depreciation often represents depreciation of nonrecourse liabilities when the nonrecourse liabilities begin to exceed the tax basis of the security. The “book” value of the security is substituted for tax basis of the security if “book” value and tax basis differ on account of the contribution of the property in kind to the partnership or on account of a revaluation in the “book” values of partnership assets. Nonrecourse deductions equal the annual increase in the excess of nonrecourse liabilities over tax basis (or “book” value if basis and “book” value differ).

---

849 Treasury Regulations recognize that – [allocations of losses, deductions, or Section 705(a)(2)(B) expenditures attributable to partnership nonrecourse liabilities (‘nonrecourse deductions’) cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations. Thus, nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership.


The nonrecourse deduction Treasury Regulations – provide[] a test that deems allocations of nonrecourse deductions to be in accordance with the partners’ interests in the partnership. If that test is not satisfied, the partners’ distributive shares of nonrecourse deductions are determined under section 1.704-1(b)(3), according to the partners’ overall economic interests in the partnership.

Treas. Reg. § 1.704-1(b)(1).

The preamble to Treasury Regulations on nonrecourse deductions explains:

Under section 704(b) of the Internal Revenue Code and the regulations thereunder, allocations of a partnership’s income and deductions must have substantial economic effect to be valid for federal income tax purposes – that is, they must affect, in a substantial way, the economic stakes of the partners in the partnership apart from the tax consequences. The substantial economic effect portion of the section 704(b) regulations (section 1.704-1(b)(1) and (b)(2)) contains a number of requirements designed to ensure that partners who are allocated losses bear the economic (footnote continued on the next page)
a. **Nonrecourse Liability.**

The starting point in considering “nonrecourse deductions” is to consider “nonrecourse liability.” Nonrecourse liabilities produce nonrecourse deductions. The annual increase in nonrecourse liabilities over the “book” value of the security equals “minimum gain.” Nonrecourse deductions equal the annual increase in minimum gain – or the annual increased in nonrecourse liabilities over the “book” value of the security. Nonrecourse liabilities generally are liabilities where neither a partner nor an affiliate bears the economic risk of loss on a constructive liquidation of the partnership if the partnership does not adequate assets to satisfy the liability. The constructive liquidation involves these steps:

The burden associated with those losses, and partners who are allocated income receive the economic benefit associated with that income. Allocations that do not have substantial economic effect under the tests in the section 704(b) regulations are reallocated according to the partners’ interests in the partnership.

Nonrecourse liabilities are liabilities for which no partner is personally liable. Accordingly, allocations of deductions attributable to partnership nonrecourse liabilities (nonrecourse deductions) cannot have substantial economic effect because the nonrecourse lender, rather than the partners, ultimately bears any economic loss attributable to those deductions. Similarly, allocations of the gain that would be realized if the property securing the debt were surrendered for no consideration other than full satisfaction of the liability cannot have substantial economic effect because these allocations merely offset the nonrecourse deductions.

The final regulations provide rules that: (1) determine when a partnership has nonrecourse deductions; (2) provide a safe harbor, including a minimum gain chargeback requirement, under which allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership; and (3) determine when a partnership must allocate income to the partners who were previously allocated nonrecourse deductions, pursuant to the minimum gain chargeback requirement.


850 Treas. Reg. § 1.704-2(b)(3) (“‘Nonrecourse liability’ means a nonrecourse liability as defined in section 1.752-1(a)(2) or a § 1.752-7 liability (as defined in § 1.752-7(b)(3)(i)) assumed by the partnership from a partner on or after June 24, 2003.’”). We will later review Section 1.752-7 liabilities in more detail. This is a contingent liability assumed by the partnership. See discussion in text accompanying note 1148. Treas. Reg. § 1.752-1(a)(2) (“A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the econ-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

• All of the partnership’s liabilities become payable in full;
• With the exception of property contributed to secure a partnership liability, all of the partnership’s assets (including cash) have a value of zero;
• The partnership disposes of all of its property in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor’s right to repayment is limited solely to one or more assets of the partnership);
• All items of income, gain, loss, or deduction are allocated among the partners; and
• The partnership liquidates.\textsuperscript{851}

Special rules govern the situation in which a partner or a related person makes (or acquires an interest in) a nonrecourse loan to the partnership and the economic risk of loss for the liability is not borne by another partner. The partner lender or person related to the lender is treated as bearing the economic risk of loss.\textsuperscript{852}

\textsuperscript{851} Treas. Reg. § 1.752-2(b)(1). \textsuperscript{852} There is, in fact, considerable uncertain about what nonrecourse liabilities create nonrecourse deductions. This results to a significant extent from the introduction of limited liability companies and changes in finance procedures. Many liabilities are fully recourse to the partnership but nonrecourse to the partners. These “excumulatory liabilities” do not clearly create nonrecourse deductions, since it is not clear that these liabilities are nonrecourse for purposes of Section 1001. Similarly, recourse on liabilities may be confined to the assets of a single member limited liability company that acts as a special purpose entity. The liability may be recourse in form, yet limited to a single asset as a practical matter. It is not clear whether such a liability produces nonrecourse deductions. A liability may be nonrecourse in form, yet guaranteed by a partner through a “bad boy,” “bad acts,” or “nonrecourse carve-out guarantee.” The set of prohibited acts is becoming extensive, going far beyond concerns with fraud and waste. It is unclear when such a guarantee can cause liabilities to become recourse liabilities for purposes of Sec-

(footnote continued on the next page)
b. 10 Percent or Less Partner Lender.

An exception can apply when the lender is a 10 percent or smaller partner. A loan from a partner, when this exception applies, is treated as nonrecourse debt for purposes of both the partnership rules for allocating liabilities among partners (Section 752) and for purposes of the partnership allocation rules (Section 704). This can be a useful rule for the partnership agreement draftsman who knows it or a dangerous trap for the partnership agreement draftsman who does not.

A “related person” is defined carefully and extensively for this purpose in the Code and in Treasury Regulations. A practitioner needs the skill of a sur-

---

853 Treas. Reg. § 1.752-2(d)(1) (“Partner as Lender. The general rule contained in paragraph (c)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).”), (2) (“Partner as Guarantor. The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.”).

854 Treas. Reg. § 1.752-4(b) (“(b) Related Person Definition (1) In General. A person is related to a partner if the person and the partner bear a relationship to each other that is specified in sections 267(b) or 707(b)(1), subject to the following modifications: (i) Substitute ‘80 percent or more’ for ‘more than 50 percent’ each place it appears in those sections; (ii) A person's family is determined by excluding brothers and sisters; and (iii) Disregard sections 267(e)(1) and 267(f)(1)(A). (2) Person Related To More Than One Partner (i) In General. If, in applying the related person rules in paragraph (b)(1) of this section, a person is (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

geon and the patience of a saint to apply these rules correctly. Few aspects of the tax laws would benefit more from seriously reconsideration than the definitions of “related persons.”

The general rule that treats partner-loaned debt as recourse indebtedness “does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, makes a related to more than one partner, paragraph (b)(1) of this section is applied by treating the person as related only to the partner with whom there is the highest percentage of related ownership. If two or more partners have the same percentage of related ownership and no other partner has a greater percentage, the liability is allocated equally among the partners having the equal percentages of related ownership. (ii) Natural Persons. For purposes of determining the percentage of related ownership between a person and a partner, natural persons who are related by virtue of being members of the same family are treated as having a percentage relationship of 100 percent with respect to each other. (iii) Related partner exception. Notwithstanding paragraph (b)(1) of this section (which defines related person), persons owning interests directly or indirectly in the same partnership are not treated as related persons for purposes of determining the economic risk of loss borne by each of them for the liabilities of the partnership. This paragraph (iii) does not apply when determining a partner's interest under the de minimis rules in section 1.752-2(d) and (e). (iv) Special Rule Where Entity Structured To Avoid Related Person Status (A) In General. If — (1) A partnership liability is owed to or guaranteed by another entity that is a partnership, an S corporation, a C corporation, or a trust; (2) A partner or related person owns (directly or indirectly) a 20 percent or more ownership interest in the other entity; and (3) A principal purpose of having the other entity act as a lender or guarantor of the liability was to avoid the determination that the partner that owns the interest bears the economic risk of loss for federal income tax purposes for all or part of the liability; then the partner is treated as holding the other entity's interest as a creditor or guarantor to the extent of the partner's or related person's ownership interest in the entity. (B) Ownership Interest. For purposes of paragraph (b)(2)(iv)(A) of this section, a person's ownership interest in: (1) A partnership equals the partner's highest percentage interest in any item of partnership loss or deduction for any taxable year; (2) An S corporation equals the percentage of the outstanding stock in the S corporation owned by the shareholder; (3) A C corporation equals the percentage of the fair market value of the issued and outstanding stock owned by the shareholder; and (4) A trust equals the percentage of the actuarial interests owned by the beneficial owner of the trust.”).
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

Loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed). This is a technical and nuanced exception that requires threading a needle through a series of complicated cross-references. This exception commonly applies to real estate partnerships.

The indebtedness (to qualify for the exclusion that treats partner loans as nonrecourse debt) must be –

- Borrowed from a “qualified person” (as defined below) or
- A loan from any Federal, State, or local government or instrumentality thereof, or
- Guaranteed by any Federal, State, or local government, for this exception to apply.

Such a liability is treated as a nonrecourse liability rather than a recourse liability, even though a partner is the lender. As you explore “qualified person,” you will see that this is limited to parties that are involved in the regular and active business of lending money. Probing the nuances of what this means is beyond the scope of this Article, but it requires more than making a few passive loans.

This exception (for the indebtedness to qualify for the exclusion that treats partner loans as nonrecourse debt) does not apply if the partner has an interest in any item of partnership income, gain, loss, deduction, or credit that is more than 10 percent. Treasury Regulations do not address materiality of them item. This requires careful scrutiny of all allocations in the partnership agreement. The 10 percent test aggregates the interests held by the partner or related persons and considers both direct interests and interests held through one or more partnerships. The 10 percent computation throws a wide net to include in its computation any interests held by related persons.

The exception (for the indebtedness to qualify for the exclusion that treats partner loans as nonrecourse debt) requires that:

- No person is personally liable for repayment, and
- The indebtedness is not convertible debt (normally, convertible into an equity interest in the partnership).

Plumbing these requirements is outside of the scope of this Article.

---

855 Treas. Reg. § 1.752-2(d)(1).
856 It is not clear whether “any item” always will mean quite any item – whether the partnership will be able to manipulate the rule by creating tiny special allocations.
Section 465(b)(6) additionally requires that the financing “is borrowed by the taxpayer with respect to the activity of holding real property.” This requirement appears to be eliminated for purposes of determining recourse and nonrecourse debt under the partnership rules for allocating liabilities among partners (Section 752): “a loan to the partnership which constitutes qualified nonrecourse financing within the meaning of section 465(b)(6) (determined without regard to the type of activity financed).”


Section 465(b)(6) provides:

(6) Qualified nonrecourse financing treated as amount at risk. For purposes of this section—

(A) In general. Notwithstanding any other provision of this subsection, in the case of an activity of holding real property, a taxpayer shall be considered at risk with respect to the taxpayer’s share of any qualified nonrecourse financing which is secured by real property used in such activity.

(B) Qualified nonrecourse financing. For purposes of this paragraph, the term “qualified nonrecourse financing” means any financing—

(i) which is borrowed by the taxpayer with respect to the activity of holding real property,

(ii) which is borrowed by the taxpayer from a qualified person or represents a loan from any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government,

(iii) except to the extent provided in regulations, with respect to which no person is personally liable for repayment, and

(iv) which is not convertible debt.

(C) Special rule for partnerships. In the case of a partnership, a partner’s share of any qualified nonrecourse financing of such partnership shall be determined on the basis of the partner’s share of liabilities of such partnership incurred in connection with such financing (within the meaning of section 752).

(D) Qualified person defined. For purposes of this paragraph—

(i) In general. The term “qualified person” has the meaning given such term by section 49(a)(1)(D)(iv).

(ii) Certain commercially reasonable financing from related persons. For purposes of clause (i), section 49(a)(1)(D)(iv) shall be applied without regard to subclause (I) thereof (relating to financing from related persons) if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.

(footnote continued on the next page)
c. Partner Guaranteed Loans.

A similar and roughly parallel rule applies to treat a loan guaranteed by a partner as a nonrecourse debt. This rule is particularly important when partners guarantee the nonrecourse financing of the partnership in order to give those partners increased tax basis in their partnership interests. This guarantor rule applies only if the loan would constitute “qualified nonrecourse financing” if the guarantor were the lender. This rule considerably confines the scope of partner-guaranteed loans that qualify for the exception that treats partner-guaranteed loan as nonrecourse debt. The exception that treats partner-guaranteed loans as nonrecourse debt generally is limited to a guaranteeing partner who is “actively and

(E) Activity of holding real property. For purposes of this paragraph—
   (i) Incidental personal property and services. The activity of holding real property includes the holding of personal property and the providing of services which are incidental to making real property available as living accommodations.
   (ii) Mineral property. The activity of holding real property shall not include the holding of mineral property.
   (iv) Qualified persons. For purposes of this paragraph, the term “qualified person” means any person which is actively and regularly engaged in the business of lending money and which is not—
      (I) a related person with respect to the taxpayer,
      (II) a person from which the taxpayer acquired the property (or a related person to such person), or
      (III) a person who receives a fee with respect to the taxpayer’s investment in the property (or a related person to such person).


Clause (I) concerning “a related person with respect to the taxpayer” does not apply, for this purpose, “if the financing from the related person is commercially reasonable and on substantially the same terms as loans involving unrelated persons.” The lender, in any event, must be “actively and regularly engaged in the business of lending money.” Probing these concepts is outside of the scope of this Article.

Commercially reasonable financing, according to the legislative history, requires that the financing is “a written unconditional promise to pay on demand or on a specified date or dates a sum or sums certain in money, and the interest rate is a reasonable market rate of interest (taking into account the maturity of the obligation).” The financing is not commercially reasonable if the interest rate is significantly different from the rate that is charged on comparable loans by unrelated persons. Id.
regularly engaged in the business of lending money.” The exception that treats the loan guaranteed by a 10 percent or less partner as nonrecourse debt does not apply unless either (i) the partner is actively and regularly engaged in the business of lending money, or (ii) the partner is any Federal, State, or local government or instrumentality thereof, or is guaranteed by any Federal, State, or local government. \(^{858}\)

d. Nonrecourse Deductions.

The amount of the partnership’s annual nonrecourse deductions is defined in terms of the annual increase in minimum gain — or nonrecourse liabilities in excess of the “‘book’” value of the security for those nonrecourse liabilities. Nonrecourse deductions are treated as a specially allocated item under Section 702(a), tested separately from the bottom line allocation. Nonrecourse deductions often are produced by the depreciation of property subject to nonrecourse liabilities. \(^{859}\)

\(^{858}\) Treas. Reg. § 1.752-2(d)(2) (“The general rule contained in paragraph (b)(1) of this section does not apply if a partner or related person whose interest (directly or indirectly through one or more partnerships including the interest of any related person) in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the partner is a partner in the partnership is 10 percent or less, guarantees a loan that would otherwise be a nonrecourse loan of the partnership and which would constitute qualified nonrecourse financing within the meaning of section 465(b)(6) (without regard to the type of activity financed) if the guarantor had made the loan to the partnership.”).

\(^{859}\) The preamble to Treasury Regulations concerning nonrecourse deductions explains:

II. Explanation Of The Rules Common To The Temporary And Final Regulations
A. Minimum Gain

Allocations attributable to partnership nonrecourse liabilities are based on the concept of minimum gain. The amount of minimum gain with respect to a nonrecourse liability is the gain the partnership would realize if the property securing the liability were disposed of for no consideration other than relief from the liability. Consequently, minimum gain exists to the extent the amount of the [nonrecourse] liability exceeds the property’s adjusted tax basis [or the “‘book’”-value when “book” values differ from adjusted tax basis]. The amount of minimum gain increases as the difference between the property’s adjusted tax basis [or the “‘book’”-value when “book” values differ from adjusted tax basis] and the amount of the [nonrecourse] liability gets larger (for example as depreciation deductions are taken); minimum gain decreases as the difference between the property’s (footnote continued on the next page)
adjusted tax basis [or the “book”-value when “book” values differ from adjusted tax basis] and the amount of the [nonrecourse] liability gets smaller (for example if the property subject to the debt is disposed of or if the liability is paid).

B. Nonrecourse Deductions

In any taxable year, the amount of a partnership’s nonrecourse deductions equals the net increase in the partnership’s minimum gain reduced by any distributions of nonrecourse debt proceeds that are allocable to an increase in partnership minimum gain. A net increase or decrease in the partnership’s minimum gain is an aggregate figure that is determined by comparing the current year’s minimum gain with the prior year’s minimum gain. If the partnership has a net increase in minimum gain, partnership deductions are generally treated as nonrecourse deductions to the extent of the net increase. Nonrecourse deductions must be allocated in accordance with the partners’ interests in the partnership. The regulations provide a safe harbor under which an allocation of nonrecourse deductions is deemed to be in accordance with the partners’ interests in the partnership. If the partnership has a net decrease in minimum gain, generally the minimum gain chargeback rules require income to be allocated to the partners who were previously allocated nonrecourse deductions or received distributions attributable to nonrecourse debt proceeds.

The partnership’s nonrecourse deductions consist first of depreciation or cost recovery deductions from property subject to nonrecourse debt. If there are not enough depreciation or cost recovery deductions to cover the partnership’s nonrecourse deductions, a pro rata portion of the partnership’s other deductions are treated as nonrecourse deductions. If the amount of nonrecourse deductions exceeds these other items, then the excess is treated as an increase in partnership minimum gain (to be aggregated with any other minimum gain increases and decreases) for the next taxable year.

C. Allocations Of Nonrecourse Deductions And Minimum Gain Chargebacks

Allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership if certain requirements are met. First, the partnership must meet all of the requirements of the economic effect rules under section 1.704-1(b) of the regulations (The final regulations clarify the temporary regulations by explicitly listing the requirement that partners agree to a qualified income offset or an unconditional deficit restoration obligation with the other economic effect requirements that must be satisfied.) Second, the partnership must allocate (footnote continued on the next page)
Nonrecourse deductions for a taxable year are generally equal to the net increase in partnership minimum gain over the prior year. Increases in minimum gain for the partnership’s taxable year are netted across all partnership liabilities for the partnership’s taxable year.860

the nonrecourse deductions in a manner that reasonably consistent with the allocation that has substantial economic effect of another significant item attributable to property secured by nonrecourse debt (the reasonable consistency requirement). Finally, the partnership agreement must also contain a minimum gain chargeback provision that complies with the regulations. . . .

The reasonable consistency requirement governs the ratio in which the partners are permitted to share the nonrecourse deductions. The ratio for sharing nonrecourse deductions must correspond to other allocations that are related to the nonrecourse deductions and that have substantial economic effect. The examples illustrate situations that meet the reasonable consistency requirement where the nonrecourse deductions are allocated according to how the partners share losses or profits, or any ratio between those two figures.

T.D. 8385, 56 Fed. Reg. 66978-66995 (December 27, 1991). See Treas. Reg. § 1.704-2(c) (“The amount of nonrecourse deductions for a partnership taxable year equals the net increase in partnership minimum gain during the year (determined under paragraph (d) of this section), reduced (but not below zero) by the aggregate distributions made during the year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain (determined under paragraph (h) of this section). . . . However, increases in partnership minimum gain resulting from conversions, refinancings, or other changes to a debt instrument (as described in paragraph (g)(3)) do not generate nonrecourse deductions. Generally, nonrecourse deductions consist first of certain depreciation or cost recovery deductions and then, if necessary, a pro rata portion of other partnership losses, deductions, and Section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over. . . .”).

860 Treas. Reg. § 1.704-2(d)(1) (“The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by

(footnote continued on the next page)
The net increase in minimum gain for the partnership’s taxable year is reduced (but not below zero) by aggregate distributions during the partnership’s taxable year of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain. A partnership distribution to the partners is allocable to an increase in partnership minimum gain among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain to the extent that the increase results from encumbering partnership property with aggregate nonrecourse liabilities that exceed the property’s adjusted tax basis. The net increase in partnership minimum gain for a partnership taxable year may be allocable to more than one nonrecourse liability. The net increase is allocated among the liabilities in proportion to the amount each liability contributed to the increase in minimum gain. A partnership may use any reasonable method to determine whether a distribution by the partnership to one or more partners is allocable to proceeds of a nonrecourse liability. An example of a reasonable method is provided by the interest tracing rules of Treasury Regulations Section 1.163-8T.861

The increases in partnership minimum gain that result from conversions of debt from nonrecourse to recourse, refinancings of nonrecourse debt with recourse debt, and other changes to a debt instrument do not generate nonrecourse deductions.

Generally, nonrecourse deductions consist:

- First, of certain depreciation or cost recovery deductions (until exhausted), and then
- If necessary, a pro rata portion of other partnership losses, deductions, and Section 705(a)(2)(B) expenditures for that year; excess nonrecourse deductions are carried over.862

Nonrecourse deductions are “book” deductions if a “book”-tax disparity exists. The corresponding tax deduction is allocated following principles of the

861 Treas. Reg. § 1.704-2(h).
862 Treas. Reg. § 1.704-2(c).
rules for allocating taxable losses when a disparity exists between “book” income and taxable income.

e. **Nonrecourse Deduction Allocation Rule.**

Treasury Regulations set forth these formal requirements to be satisfied by allocations of nonrecourse deductions:

- Throughout the full term of the partnership requirements (1) and (2) of Treasury Regulations Section 1.704-1(b)(2)(ii)(b) are satisfied (that is, capital accounts are maintained in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either Treasury Regulations Section 1.704-1(b)(2)(ii)(b) or Section 1.704-1(b)(2)(ii)(d) is satisfied (that is, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset).  

- Beginning in the first taxable year of the partnership in which nonrecourse deductions occur and thereafter throughout the full term of the partnership, partnership agreement sets forth allocations of nonrecourse deductions 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.

- Beginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership, your partnership agreement contains a provision that complies with the minimum gain chargeback requirement of Treasury Regulations Section 1.704-2(f).

- All other material allocations and capital account adjustments under your partnership agreement are recognized under Treasury Regulations Section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under Sec-

---

865 Treas. Reg. § 1.704-2(e)(3).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tion 613A(c)(7)(D) are recognized under Treasury Regulations Section 1.704-1(b)(4)(v)).

You might ask what happens if your partnership agreement violates the nonrecourse deduction safe harbor. Treasury Regulations provide: “the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners’ overall economic interests in the partnership, determined under section 1.704-1(b)(3)(ii).” This deprives you of the ability to specially allocate nonrecourse deductions if your partnership agreement violates the nonrecourse deduction safe harbor. Partnership case law, statutory law and administrative law are not clear how nonrecourse deductions should be allocated “according to the partners’ overall economic interests in the partnership.”

Requirements (1) and (2) of Treasury Regulations Section 1.704-1(b)(2)(ii)(b) are satisfied (that is, capital accounts are maintained in accordance with Treasury Regulations Section 1.704-1(b)(2)(iv) and liquidating distributions are required to be made in accordance with positive capital account balances), and requirement (3) of either Treasury Regulations Section 1.704-1(b)(2)(ii)(b) or Section 1.704-1(b)(2)(ii)(d) is satisfied (that is, partners with deficit capital accounts have an unconditional deficit restoration obligation or agree to a qualified income offset). This must be satisfied throughout the full term of the partnership. You have dealt with these demanding requirements in the discussions above of economic effect and alternate economic effect. Your partnership agreement must satisfy either economic effect or alternate economic effect. Your partnership agreement must satisfy one of these rules throughout the full term of the partnership. A day’s lapse theoretically is fatal. Treasury Regulations do not provide tolerance for error. Your partnership agreement must satisfy these requirements absolutely and at all times. That, at least, is what Treasury Regulations say. Treasury Regulations perhaps will be interpreted with greater leniency by the courts. Treasury Regulations do not provide for rehabilitation if the partnership ever fails to satisfy economic effect or alternate economic effect.

Having allocations satisfy the test of “in accordance with the partner’s interest in the partnership” does not meet this requirement. An element of the choice to disregard the requirements of economic effect and alternate economic effect and to follow the trail of “in accordance with the partner’s interest in the partnership” is that your partnership agreement will not satisfy the requirements of the nonrecourse deduction allocation safe harbor. The courts perhaps could relax this

aspect of Treasury Regulations. Why an allocation that is respected for tax purposes should disqualify the partnership agreement from the nonrecourse deduction safe harbor, is not clear.

Your partnership agreement must provide for allocations of nonrecourse deductions 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. This requirement must be satisfied at all instants beginning in the first taxable year of the partnership in which nonrecourse deductions appear. Perhaps this statement should be relaxed to permit retroactive amendments to the partnership agreement for the first taxable year in which the partnership has nonrecourse deductions. Section 761(c) provides: “For purposes of this subchapter, a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided by the partnership agreement.” This permits certain retroactive modifications to the partnership agreement.

Treasury Regulations do not tell you what it means to be “reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.” You can dissect this phrase into its basic components:

- Reasonably consistent with
- Allocations that have substantial economic effect of
- Some other significant partnership item
- Attributable to the property securing the nonrecourse liabilities.

“Reasonably consistent” is not defined in Treasury Regulations. You might infer that this means “more or less consistent” or something like that. This is not precisely what examples in Treasury Regulations describe. Example in Treasury Regulations appear to interpret reasonably consistent by using the various “allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities” as percentage guideposts. Any allocation of nonrecourse deductions within the limits imposed by the outlying guideposts is “reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.” Any allocation of nonrecourse deductions that is far outside of the limits imposed by the out-

---

lying guideposts apparently is not “reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities.” The guideline allocations perhaps should be treated as creating a fuzzy boundary, so that allocations close to those guideline allocations are “reasonably consistent” with those guideline allocations.\textsuperscript{870} How close is close enough, is not clear under partnership case law, statutory law and administrative law.

The nonrecourse deduction allocations must be reasonably consistent with items that have substantial economic effect. This includes deemed substantial economic effect under the alternate test for economic effect. Allocations that are merely in accordance with the partner’s interest in the partnership apparently are not good enough.

A partnership agreement that fails substantial economic effect (including the alternate test for economic effect) fails the nonrecourse deduction safe harbor. The nonrecourse deduction safe harbor requires either full compliance with substantial economic effect or full compliance with the alternate test for economic effect.

The scope and contours of “reasonably consistent with allocations that have substantial economic effect of some other significant partnership item attributable to the property securing the nonrecourse liabilities” are not well defined in Treasury Regulations. The allocations with which the nonrecourse deduction allocations must be reasonably consistent must be other “significant” partnership items. These other significant partnership items must be other significant partnership items that are attributable to the property securing the nonrecourse liabilities. This provides further evidence that nonrecourse liabilities must be secured.\textsuperscript{871} The common other items with which the nonrecourse deduction allocations should be reasonably consistent are significant allocations of nonrecourse depreciation with respect to the security. This is not the only permitted guideline allocation. The guideline allocation can be any other significant item attributable to the security. This other guideline allocation, when the security is used in a trade or business,

\textsuperscript{870} But cf. Tech. Adv. Mem. 200436011 (Apr. 30, 2004) (partner receives an allocation of 100\% of gross receipts up to an annually specified amount; this does not qualify as a guideline allocation for allocating nonrecourse liabilities; the guideline allocation must be based on an allocation of an entire item of income or gain). See Treas. Reg. § 1.704-1(b)(5), Example (20) (losses are shared 90/10; profits are there 90/10 until losses are charged back and then 50/50; both 90/10 and 50/50 allocations are significant; any allocation between those guideline ratios satisfies the safe harbor; 99/1 allocation is not reasonably consistent).

\textsuperscript{871} Query: Must the security interest be perfected?
might be a significant item of income from that business – if a reasonable case can be made that this income is attributable to the security. The proximity of the property securing the nonrecourse liabilities and the partnership item is not clarified in Treasury Regulations. How significant a “significant partnership item” must be is not properly clarified in Treasury Regulations. The reasonably consistent test drills down into partnership items; it is not limited to bottom line allocations. Nonrecourse deductions often are disaggregated from bottom line Net Losses.

The partnership agreement must have a minimum gain chargeback “[b]eginning in the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain, and thereafter throughout the full term of the partnership.” Examples of minimum gain chargebacks are set forth in the vicinity of note 611. The minimum gain chargeback requirement appears to require an explicit qualifying minimum gain chargeback. Treasury Regulations appear to require that a minimum gain chargeback may be implied in your partnership agreement whether or not it is set forth explicitly. The minimum gain chargeback must be compliant with Treasury Regulations – apparently fully compliant.

There technically is no requirement for the partnership agreement to contain a minimum gain chargeback provision prior to “the first taxable year of the partnership that it has nonrecourse deductions or makes a distribution of proceeds of a nonrecourse liability that are allocable to an increase in partnership minimum gain.” Good drafting, however, usually requires that a partnership agreement for any partnership agreement that might have nonrecourse deductions contain a qualifying minimum gain chargeback.

The minimum gain chargeback requirement is violated if the minimum gain chargeback provision should ever lapse from the first day that it is required. The minimum gain chargeback must be contained in your partnership agreement “thereafter throughout the full term of the partnership.”

The final requirement of the nonrecourse deduction safe harbor is that: “All other material allocations and capital account adjustments under your partnership agreement are recognized under Treasury Regulations Section 1.704-1(b) (without regard to whether allocations of adjusted tax basis and amount realized under Section 613A(c)(7)(D) are recognized under Treasury Regulations Section 1.704-1(b)(4)(v)).” This requirement requires rigorous adherence to the

---

capital account accounting rules in Treasury Regulations. This requirement does not itself require that the other material allocations have substantial economic effect. A partnership agreement relying on partner’s interest in the partnership should fail the second requirement under the nonrecourse deduction safe harbor.

These principles are illustrated in an example from Treasury Regulations:

Example 1. Nonrecourse Deductions and Partnership Minimum Gain. For Example 1, unless otherwise provided, the following facts are assumed. LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes $180,000, and GP contributes $20,000. The partnership obtains an $800,000 nonrecourse loan and purchases the building (on leased land) for $1,000,000. [The partnership states with $200,000 positive equity.] The nonrecourse loan is secured only by the building, and no principal payments are due for 5 years. The partnership agreement provides that GP will be required to restore any deficit balance in GP’s capital account following the liquidation of GP’s interest (as set forth in section 1.704-1(b)(2)(ii)(b)(3)), and LP will not be required to restore any deficit balance in LP’s capital account following the liquidation of LP’s interest. [This is the typical arrangement.] The partnership agreement contains the following provisions required by paragraph (e) of this section: a qualified income offset (as defined in section 1.704-1(b)(2)(ii)(d)); a minimum gain chargeback (in accordance with paragraph (f) of this section); a provision that the partners’ capital accounts will be determined and maintained in accordance with section 1.704-1(b)(2)(ii)(b)(1); and a provision that distributions will be made in accordance with partners’ positive capital account balances (as set forth in section 1.704-1(b)(2)(ii)(b)(2)). In addition, as of the end of each partnership taxable year discussed herein, the items described in section 1.704-1(b)(2)(ii)(d)(4), (5), and (6) are not reasonably expected to cause or increase a deficit balance in LP’s capital account. [These appears to mean that an expectation of these adjustments in unreasonable.] The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP. Finally, the partnership agreement provides that all distributions, other than distributions in liquidation of the partnership or of a partner’s interest in the partnership, will be made 90 percent to LP and 10 percent to GP until a total of $200,000 has been distributed, and thereafter all the distributions will be made equally to LP and GP. In each of the partner-
ship’s first 2 taxable years, it generates rental income of $95,000, operating expenses (including land lease payments) of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000 in each of those years. [At this point, depreciation deductions total $180,000.] The allocations of these losses 90 percent to LP and 10 percent to GP have substantial economic effect.

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account</td>
<td>$180,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>on formation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: net loss in</td>
<td>(153,000)</td>
<td>(17,000)</td>
</tr>
<tr>
<td>years 1 and 2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital account</td>
<td>$27,000</td>
<td>$3,000</td>
</tr>
<tr>
<td>at end of year 2</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

[Both LP and GP have positive capital accounts after these adjustments. Note also that, at this point, there are not nonrecourse liabilities over tax basis.]

In the partnership’s third taxable year, it again generates rental income of $95,000, operating expenses of $10,000, interest expense of $80,000, and a depreciation deduction of $90,000, resulting in a net taxable loss of $85,000. The partnership makes no distributions.

(i) Calculation Of Nonrecourse Deductions And Partnership Minimum Gain. If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize $70,000 of gain ($800,000 amount realized less $730,000 adjusted tax basis). Because the amount of partnership minimum gain [nonrecourse liabilities over tax basis of the security] at the end of the third year (and the net increase in partnership minimum gain during the year) is $70,000, there are partnership nonrecourse deductions for that year of $70,000, consisting of depreciation deductions allowable with respect to the building of $70,000 [this follows from the rule that nonrecourse deductions are first comprised on nonrecourse deductions; your partnership agreement ideally should be drafted so that these nonrecourse deductions are excluded from the definition of “Net Profits” and “Net Losses”]. Pursuant to the partnership agreement, all partnership items comprising the net taxable loss of $85,000, including the $70,000 nonrecourse deduction, are allocated 90 percent to LP and 10 percent to GP. The allocation of these items, other than the nonrecourse deductions, has substantial economic effect [under the alternate test for economic effect].
The allocation of the $70,000 nonrecourse deduction satisfies requirement (2) of paragraph (e) of this section because it is consistent with allocations having substantial economic effect of other significant partnership items attributable to the building. It is consistent in the sense that it is identical to the allocation of recourse deductions; these are the two allocations of gain or income: “The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP.” Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners’ interests in the partnership. At the end of the partnership’s third taxable year, LP’s and GP’s shares of partnership minimum gain are $63,000 and $7,000, respectively [these are their cumulative shares of nonrecourse deductions]. Therefore, pursuant to paragraph (g)(1) of this section, LP is treated as obligated to restore a deficit capital account balance of $63,000 [equal to his cumulative share of nonrecourse deductions], so that in the succeeding year LP could be allocated up to an additional $13,500 of partnership deductions [under the alternate test for economic effect], losses, and Section 705(a)(2)(B) items that are not nonrecourse deductions. Even though this allocation would increase a deficit capital account balance, it would be considered to have economic effect under the alternate economic effect test contained in section 1.704-1(b)(2)(ii)(d). If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the beginning of the partnership’s fourth taxable year (and had no other economic activity in that year), the partnership minimum gain would be decreased from $70,000 to zero, and the minimum gain chargeback would require that LP and GP be allocated
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

$63,000 and $7,000 [effectively charging back past nonrecourse deductions with a gain allocation under the minimum gain chargeback], respectively, of the gain from that disposition [the minimum gain chargeback charges back and reverses prior nonrecourse deductions when the minimum gain is reduced].

(ii) Illustration Of Reasonable Consistency Requirement. Assume instead that the partnership agreement provides that all nonrecourse deductions of the partnership will be allocated equally between LP and GP. Furthermore, at the time the partnership agreement is entered into, there is a reasonable likelihood [note the example does not say quite what this means] that over the partnership’s life [this looks to the whole life of the partnership] it will realize amounts of income and gain significantly in excess of amounts of loss and deduction (other than nonrecourse deductions). The equal allocation of excess income and gain has substantial economic effect [under the alternate test for economic effect].

<table>
<thead>
<tr>
<th></th>
<th>LP</th>
<th>GP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$180,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Less: net loss in years 1 and 2</td>
<td>(153,000)</td>
<td>(17,000)</td>
</tr>
<tr>
<td>Less: net loss in year 3 (without nonrecourse deductions)</td>
<td>(13,500)</td>
<td>(1,500)</td>
</tr>
<tr>
<td>Less: nonrecourse deductions in year 3</td>
<td>(35,000)</td>
<td>(35,000)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($21,500)</td>
<td>($33,500)</td>
</tr>
</tbody>
</table>

The allocation of the $70,000 nonrecourse deduction equally between LP and GP satisfies requirement (2) of paragraph (e) of this section because the allocation is consistent with allocations, which will have substantial economic effect, of other significant partnership items attributable to the building [the partnership agreement provides for these allocations: “The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP”; an allocation between these two allocations
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

should be “reasonably consistent”]. Because the remaining requirements of paragraph (e) of this section are satisfied, the allocation of nonrecourse deductions is deemed to be in accordance with the partners’ interests in the partnership [under the alternate test for economic effect]. The allocation of the nonrecourse deductions 75 percent to LP and 25 percent to GP (or in any other ratio between 90 percent to LP/10 percent to GP and 50 percent to LP/50 percent to GP) also would satisfy requirement (2) of paragraph (e) of this section [the partnership agreement provides for these allocations: “The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP”; an allocation between these two allocations should be “reasonably consistent”).

(iii) Allocation Of Nonrecourse Deductions That Fails Reasonable Consistency Requirement. Assume instead that the partnership agreement provides that LP will be allocated 99 percent, and GP 1 percent, of all nonrecourse deductions of the partnership. Allocating nonrecourse deductions this way does not satisfy requirement (2) of paragraph (e) of this section because the allocations are not reasonably consistent with allocations, having substantial economic effect, of any other significant partnership item attributable to the building [the partnership agreement provides for these allocations: “The partnership agreement provides that, except as otherwise required by its qualified income offset and minimum gain chargeback provisions, all partnership items will be allocated 90 percent to LP and 10 percent to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life, and all further partnership items will be allocated equally between LP and GP”; an allocation between these two allocations should be “reasonably consistent”; a 99:1 allocation is outside of the boundaries described by the other allocations]. Therefore, the allocation of nonrecourse deductions will be disregarded, and the nonrecourse deductions of the partnership will be reallocated according to the partners’ overall economic interests in the partnership, determined under section 1.704-1(b)(3)(ii) [establishing how the nonrecourse deduction items are allocated under this standard can be a challenge in the context of a complicated partnership agreement].

Treasury Regulations prescribe a special rule for the partnership’s taxable year of the revaluation of partnership assets. On a permitted revaluation, the net increase or decrease in partnership minimum gain for the partnership taxable year of the revaluation is determined by:

- First, calculating the net decrease or increase in partnership minimum gain using the current year’s book values and the prior year’s partnership minimum gain amount; and
- Then, adding back any decrease in minimum gain arising solely from the revaluation.

The net increases or decreases in partnership minimum gain, when the partners’ capital accounts are decreased to reflect a revaluation of the assets of the partnership, are determined in the same manner as in the partnership’s taxable year before the revaluation, but by using book values rather than adjusted tax bases.

134. Minimum Gain Chargeback.

The minimum gain chargeback is one of the bedrock requirements of the nonrecourse deduction safe harbor. An example of the minimum gain chargeback is illustrated in the text at note 611. The function of the minimum gain chargeback is to create allocations of gross “book” income to reverse prior allocations of non-recourse deductions when minimum gain is reduced. The minimum gain chargeback often will apply on the sale of the security for the nonrecourse debt or on repayment of the nonrecourse debt.

The preamble to the final regulations on nonrecourse deductions explains:

Allocations of nonrecourse deductions are deemed to be in accordance with the partners’ interests in the partnership if certain requirements are met. First, the partnership must meet all of the requirements of the economic effect rules under section 1.704-1(b) of the regulations. (The final regulations clarify the temporary regulations by explicitly list-

---


875 More formally, “If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain.” Treas. Reg. § 1.704-2(f)(1).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ing the requirement that partners agree to a qualified income offset or an unconditional deficit restoration obligation with the other economic effect requirements that must be satisfied.) Second, the partnership must allocate the nonrecourse deductions in a manner that reasonably consistent with the allocation that has substantial economic effect of another significant item attributable to property secured by nonrecourse debt (the reasonable consistency requirement). Finally, the partnership agreement must also contain a minimum gain chargeback provision that complies with the regulations. . . .

The reasonable consistency requirement governs the ratio in which the partners are permitted to share the nonrecourse deductions. The ratio for sharing nonrecourse deductions must correspond to other allocations that are related to the nonrecourse deductions and that have substantial economic effect. The examples illustrate situations that meet the reasonable consistency requirement where the nonrecourse deductions are allocated according to how the partners share losses or profits, or any ratio between those two figures.

Generally, when a partnership has a net decrease in minimum gain, there is a requirement to charge back minimum gain (the minimum gain chargeback requirement) . . . . The minimum gain chargeback requirement ensures that the nonrecourse deductions are replaced with income allocations at the appropriate time. The partnership’s income used to satisfy the minimum gain chargeback requirement first consists of gains from the sale of property subject to nonrecourse debt. Any remaining minimum gain chargeback requirement is satisfied with a pro rata portion of the partnership’s other items of income and gain (except gain from the sale of property subject to partner nonrecourse debt, which is treated separately). If there are not enough income items to satisfy the minimum gain chargeback requirement, the excess is carried over as a minimum gain chargeback requirement to succeeding taxable years until there is enough income to satisfy the minimum gain chargeback requirement. In certain circumstances, the temporary and the final regulations permit deferral of the minimum gain chargeback requirement until the occurrence of a subsequent event that triggers the chargeback. The temporary and final regulations also do not require the chargeback of minimum gain to a partner if the partner’s share of minimum gain is or will be replaced with capital contributions.\textsuperscript{876}

The preamble further provides:

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The final regulations contain a minimum gain chargeback requirement (for both nonrecourse and partner nonrecourse debt), with appropriate exceptions, based exclusively on the partners’ shares of minimum gain. Specifically, a partner’s minimum gain chargeback equals the partner’s share of the partnership’s net decrease in minimum gain. A partner’s share of the net decrease is measured by that partner’s percentage share of the partnership’s total minimum gain. For example, if a partner had a 20 percent share of the partnership’s total minimum gain and the partnership had a net decrease in minimum gain of $500, the partner’s share of the net decrease (and minimum gain chargeback) is $100 (20 percent of $500). A partner’s share of minimum gain equals the sum of all past nonrecourse deductions allocated to the partner and distributions attributable to nonrecourse debt proceeds received by the partner; those are the items that need to be restored by the minimum gain chargeback requirement.

A number of exceptions to the mandatory minimum gain chargeback are included to address inappropriate chargebacks. A partner is not subject to a minimum gain chargeback to the extent (1) the partner’s share of the net decrease in minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing it no longer to be partially or wholly nonrecourse, and (2) the partner bears the economic risk of loss (under the section 752 regulations) for the new liability. A chargeback is inappropriate in this circumstance because partners who bear the risk of loss for the former nonrecourse debt have replaced their nonrecourse deductions with obligations either to contribute money to the partnership or to pay the creditor if the partnership cannot pay the liability. The minimum gain chargeback also does not apply to a partner to the extent the partner contributes capital to the partnership and that capital is used to repay the nonrecourse liability.

The final regulations also contain exceptions to the minimum gain chargeback requirement for partner nonrecourse debt. If partner nonrecourse debt converts to partnership nonrecourse debt, the minimum gain chargeback is deferred. The partner is allocated a share of partnership minimum gain to the extent the chargeback is deferred and thus is subject to the deferred minimum gain chargeback when that debt is paid off or the encumbered property is sold. Other exceptions parallel the exceptions for partnership nonrecourse liabilities.

The final regulations do not allow partners to reduce their shares of minimum gain if the nonrecourse deductions (or distributions of nonrecourse debt proceeds) are restored before there is a net decrease in minimum gain. However, the Commissioner has the discretion to waive the
minimum gain chargeback requirement at the partnership’s request if the
partnership has a net decrease in minimum gain, the minimum gain
chargeback would cause economic distortions, and it is not expected that
the partnership will have sufficient other income to correct these dis-
tortions. In order for a waiver to be considered, the partnership must dem-
strate that: (1) the partners have restored the previous nonrecourse de-
ductions (and distributions of nonrecourse debt proceeds) with net income
allocations or capital contributions; and (2) the income allocations that
do not meet the minimum gain chargeback requirement more accurately
reflect the partners’ economic arrangement, as evidenced by the partner-
ship’s allocations and distributions and the partners’ contributions.877

The minimum gain chargeback is latent until minimum gain is reduced
(for example, when the property is sold). The potential gain allocation under
the minimum gain chargeback can act like a time bomb embedded in the partnership
agreement. You may draft income allocations that have the effect of reversing
prior nonrecourse deductions prior to the application of the minimum gain
chargeback. The minimum gain will remain latent. A second reversing gain allo-
cation occurs when the minimum gain is reversed. This phenomenon is material if
you draft allocation based on certain targeted values of capital account. You may
fail to take the potential latent allocation under the minimum gain chargeback into
account. The future application of the minimum gain chargeback may cause eco-
nomic distortions when the minimum gain chargeback applies. You may draft allo-
cation tiers based on capital accounts. Consider drafting your allocations based
on Adjusted Capital Accounts. These are capital accounts increased by potential
gain under the minimum gain chargeback and the partner nonrecourse debt mini-
imum gain chargeback.878

878 Treas. Reg. § 1.704-2(b)(2) (“To the extent a nonrecourse liability ex-
cedes the adjusted tax basis of the partnership property it encumbers, a disposi-
tion of that property will generate gain that at least equals that excess (‘partner-
ship minimum gain’). An increase in partnership minimum gain is created by a de-
crease in the adjusted tax basis of property encumbered by a nonrecourse liability
below the amount of that liability and by a partnership nonrecourse borrowing
that exceeds the adjusted tax basis of the property encumbered by the borrowing.
Partnership minimum gain decreases as reductions occur in the amount by which
the nonrecourse liability exceeds the adjusted tax basis of the property encum-
bered by the liability. Allocations of gain attributable to a decrease in partnership
minimum gain (a ‘minimum gain chargeback,’ as required under paragraph (f)
of this section) cannot have economic effect because the gain merely offsets non-
(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Minimum gain borrows from the Section 1001 Treasury Regulations. These Treasury Regulations provide generally that: “Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.” Treasury Regulations further state: “For purposes of this section – (i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability; . . .” The amount of the nonrecourse liability is the minimum amount realized on a sale or foreclosure.

Minimum gain corresponds to the minimum amount of gain that your partnership would recognize on a foreclosure of the security for the nonrecourse debt. The annual increase in minimum gain is referred to as “nonrecourse deductions.” When minimum gain is reduced – for example, on the sale of the security, – the minimum gain chargeback allocates gain to the partners who previously received allocations of nonrecourse deductions (to the extent of those prior allocations of nonrecourse deductions).

Allocations under the minimum gain chargeback are comprised of:

- First, gains recognized from the disposition of partnership property subject to one or more partnership nonrecourse liabilities, and then, if necessary, recourse deductions previously claimed by the partnership. Thus, to avoid impairing the economic effect of other allocations, allocations pursuant to a minimum gain chargeback must be made to the partners that either were allocated nonrecourse deductions or received distributions of proceeds attributable to a nonrecourse borrowing. . .”). Treas. Reg. § 1.1001-2(d)(1). (“The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains. The amount of partnership minimum gain includes minimum gain arising from a conversion, refinancing, or other change to a debt instrument, as described in paragraph (g)(3) of this section, only to the extent a partner is allocated a share of that minimum gain. For any partnership taxable year, the net increase or decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year.”)

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- A pro rata portion of the partnership’s other items of income and gain for that year.\textsuperscript{881}

These allocations are “book” allocations if a “book”-tax difference exists. Minimum gain chargeback allocations are an allocation of gross income items. Allocations under the minimum gain chargeback have priority over all other partnership allocations. The amount of the minimum gain chargeback requirement may exceed the partnership’s income and gains for the taxable year. The excess carries over to the next taxable year.\textsuperscript{882} This can create tax planning opportunities if the partnership can control its income.

The minimum gain chargeback does not depend on partners having negative capital accounts. The income allocation under the minimum gain chargeback will not necessarily eliminate negative capital account balances.

Treasury regulations clarify that the minimum gain chargeback does not apply to the extent that the partner’s share of the net decrease in partnership minimum gain is caused by a guarantee, refinancing, or other change in the debt instrument causing the debt to become partially or wholly recourse debt or partner nonrecourse debt, and the partner bears the economic risk of loss for the newly guaranteed, refinanced, or otherwise changed liability.\textsuperscript{883}

A special rule applies when a partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability. A partner is not subject to the minimum gain chargeback to the extent that–

- The partner contributes capital to the partnership that is used to repay the nonrecourse liability or is used to increase the basis of the property subject to the nonrecourse liability, and
- The partner’s share of the net decrease in partnership minimum gain results from the repayment or the increase to the property’s basis.\textsuperscript{884}

Treasury Regulations contain an interesting exception to the minimum gain chargeback when it would cause a distortion in the economic arrangement among the partners. This exception does not seem to have been thought through particularly well. The exception provides:

\textsuperscript{881} Treas. Reg. § 1.704-2(f)(6).
\textsuperscript{882} Id.
\textsuperscript{883} Treas. Reg. § 1.704-2(f)(2).
\textsuperscript{884} Treas. Reg. § 1.704-2(f)(3).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

In any taxable year that a partnership has a net decrease in partnership minimum gain, if the minimum gain chargeback requirement would cause a distortion in the economic arrangement among the partners and it is not expected that the partnership will have sufficient other income to correct that distortion, the Commissioner has the discretion, if requested by the partnership, to waive the minimum gain chargeback requirement. The following facts must be demonstrated in order for a request for a waiver to be considered:

(i) The partners have made capital contributions or received net income allocations that have restored the previous nonrecourse deductions and the distributions attributable to proceeds of a nonrecourse liability; and

(ii) The minimum gain chargeback requirement would distort the partners’ economic arrangement as reflected in the partnership agreement and as evidenced over the term of the partnership by the partnership’s allocations and distributions and the partners’ contributions.\textsuperscript{885}

This provision may provide relief if you have fouled up your partnership agreement. Do not depend on this provision for relief. Perhaps the key element is that the IRS must grant relief from the minimum gain chargeback requirement under the relief provision. Any economic distortion should benefit some partners and burden other partners. You may have difficulty obtaining the agreement of the partners that the minimum gain chargeback has created economic distortions. Some partners may be perfectly pleased with the operation of the minimum gain chargeback because it favors their economic position. The provision sets forth the waiver but not the modification of the minimum gain chargeback. A partnership more often would want the minimum gain chargeback to be modified rather than waiver.

Treasury Regulations illustrate the operation of the minimum gain chargeback in the context of a partnership agreement with faulty allocations:

Example 1. Partnership AB consists of two partners, limited partner A and general partner B. Partner A contributes $90 and Partner B contributes $10 to the partnership. The partnership agreement has a minimum gain chargeback provision and provides that, except as otherwise required by section 704(c), all losses will be allocated 90 percent to A and 10 percent to B; and that all income will be allocated first to restore previous losses and thereafter 50 percent to A and 50 percent to B. Distributions are made first to return initial capital to the partners and then 50

\textsuperscript{885} Treas. Reg. § 1.704-2(f)(4).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

percent to A and 50 percent to B. Final distributions are made in accordance with capital account balances. The partnership borrows $200 on a nonrecourse basis from an unrelated third party and purchases an asset for $300. The partnership’s only tax item for each of the first three years is $100 of depreciation on the asset. [This reflects the fact that depreciation normally is funded from capital before it is funded by nonrecourse debt.] A’s and B’s shares of minimum gain (under paragraph (g) of this section) and deficit capital account balances are $180 and $20 respectively at the end of the third year. [The shares of minimum gain correspond to past nonrecourse deductions and also to the excess of the nonrecourse liability over “book” value of the security.] In the fourth year, the partnership earns $400 of net operating income and allocates the first $300 to restore the previous losses (i.e., $270 to A and $30 to B) [these are operating allocations and are not yet allocations under the minimum gain chargeback; these allocations have the effect of charging back nonrecourse loss allocations with allocations of operating income; this potentially creates a double chargeback of nonrecourse deductions, as is illustrated below]; the last $100 is allocated $50 each. The partnership distributes $200 of the available cash that same year; the first $100 is distributed $90 to A and $10 to B to return their capital contributions; the last $100 is distributed $50 each to reflect their ratio for sharing profits.

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital account on formation</td>
<td>$90</td>
<td>$10</td>
</tr>
<tr>
<td>Less: net loss in years 1-3</td>
<td>($270)</td>
<td>($30)</td>
</tr>
<tr>
<td>Capital account at end of year 3</td>
<td>($180)</td>
<td>($20)</td>
</tr>
<tr>
<td>Allocation of operating income to restore nonrecourse deductions</td>
<td>$180</td>
<td>$20</td>
</tr>
<tr>
<td>Allocation of operating income to restore capital contributions</td>
<td>$90</td>
<td>$10</td>
</tr>
<tr>
<td>Allocation of operating income to reflect profits</td>
<td>$50</td>
<td>$50</td>
</tr>
<tr>
<td>Capital accounts after allocation of operating income</td>
<td>$140</td>
<td>$60</td>
</tr>
<tr>
<td>Distribution reflecting capital contribution</td>
<td>($90)</td>
<td>($10)</td>
</tr>
<tr>
<td>Distribution in profit-sharing ratio</td>
<td>($50)</td>
<td>($50)</td>
</tr>
<tr>
<td>Capital accounts following distribution</td>
<td>($0)</td>
<td>($0)</td>
</tr>
</tbody>
</table>

In the fifth year, the partnership sells the property for $300 and realizes $300 of gain. $200 of the proceeds are used to pay the nonrecourse lender. The partnership has $300 to distribute, and the partners expect to share that equally. Absent a waiver under paragraph (f)(4) of this section, the minimum gain chargeback would require the partnership to allocate the first $200 of the gain $180 to A and $20 to B, which would distort their economic arrangement [this illustrates the double chargeback, first with operating income and later with minimum chargeback gain; the minimum gain chargeback allocation does not take into account
any prior allocations of operating income not under the minimum gain chargeback]. This allocation, together with the allocation of the $100 profit $50 to each partner, would result in A having a positive capital account balance of $230 and B having a positive capital account balance of $70. The allocation of income in year 4 in effect anticipated the minimum gain chargeback that did not occur until year 5. Assuming the partnership would not have sufficient other income to correct the distortion that would otherwise result, the partnership may request that the Commissioner exercise his or her discretion to waive the minimum gain chargeback requirement and recognize allocations that would allow A and B to share equally the gain on the sale of the property. These allocations would bring the partners’ capital accounts to $150 each, allowing them to share the last $300 equally. The Commissioner may, in his or her discretion, permit this allocation pursuant to paragraph (f)(4) of this section because the minimum gain chargeback would distort the partners’ economic arrangement over the term of the partnership as reflected in the partnership agreement and as evidenced by the partners’ contributions and the partnership’s allocations and distributions [the partner who benefits from the economic distortion might prefer for the Commissioner not to exercise this discretion].

This example from Treasury Regulations shows the operation of the minimum gain chargeback in a taxable year in which the partnership does not have gross income items sufficient for the minimum gain chargeback in the partnership’s taxable year in which it first applies.

Example 2. A and B form a partnership, contribute $25 each to the partnership’s capital, and agree to share all losses and profits 50 percent each. Neither partner has an unconditional deficit restoration obligation and all the requirements in paragraph (e) of this section are met. The partnership obtains a nonrecourse loan from an unrelated third party of $100 and purchases two assets, stock for $50 and depreciable property for $100. The nonrecourse loan is secured by the partnership’s depreciable property. The partnership generates $20 of depreciation in each of the first five years as its only tax item. These deductions are properly treated as nonrecourse deductions and the allocation of these deductions 50 percent to A and 50 percent to B is deemed to be in accordance with the partners’ interests in the partnership. At the end of year five, A and B each have a $25 deficit capital account and a $50 share of partnership minimum gain. In the beginning of year six, (at the lender’s request), A guar-

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

...certifies the entire nonrecourse liability. Pursuant to paragraph (d)(1) of this section, the partnership has a net decrease in minimum gain of $100 and under paragraph (g)(2) of this section, A’s and B’s shares of that net decrease are $50 each. Under paragraph (f)(1) of this section (the minimum gain chargeback requirement), B is subject to a $50 minimum gain chargeback. Because the partnership has no gross income in year six, the entire $50 carries over as a minimum gain chargeback requirement to succeeding taxable years until there is enough income to cover the minimum gain chargeback requirement. Under the exception to the minimum gain chargeback in paragraph (f)(2) of this section, A is not subject to a minimum gain chargeback for A’s $50 share of the net decrease because A bears the economic risk of loss for the liability. Instead, A’s share of partner nonrecourse debt minimum gain is $50 pursuant to paragraph (i)(3) of this section. In year seven, the partnership earns $100 of net operating income and uses the money to repay the entire $100 nonrecourse debt (that A has guaranteed). Under paragraph (i)(3) of this section, the partnership has a net decrease in partner nonrecourse debt minimum gain of $50. B must be allocated $50 of the operating income pursuant to the carried over minimum gain chargeback requirement; pursuant to paragraph (i)(4) of this section, the other $50 of operating income must be allocated to A as a partner nonrecourse debt minimum gain chargeback.887

135. Partner Nonrecourse Deductions.

The nonrecourse deduction regulations describe a subcategory of nonrecourse liabilities (or perhaps a subcategory of recourse liabilities) that is unusual. A partner or a related person bears the economic risk of loss and the liability creates minimum gain under the Section 1001 regulations. Such a liability might be a nonrecourse loan to the partnership where a partner has guaranteed the loan. This class of liabilities is referred to as “partner nonrecourse debt.” The extent to which these liabilities exist is a matter of some conjecture. Most partnership agreements will contain special provisions that allocate deductions attributable to partner nonrecourse debt (that is, “partner nonrecourse deductions”).888

---

888 But cf. Treas. Reg. § 1.752-2(b)(2) (“Treatment Upon Deemed Disposition. For purposes of paragraph (b)(1) of this section, gain or loss on the deemed disposition of the partnership’s assets is computed in accordance with the following: (i) If the creditor’s right to repayment of a partnership liability is limited solely to one or more assets of the partnership, gain or loss is recognized in an (footnote continued on the next page)
nonrecourse deductions are made to the partner who bears the economic risk of loss. This sometimes requires a complex analysis when a loan that is nonrecourse in form is made by an affiliate of a partner.\footnote{889}

\footnote{889} The preamble to Treasury Regulations on nonrecourse deductions states:

\textit{The regulations contain rules, which generally parallel the rules applicable to nonrecourse debt, covering nonrecourse debt for which a partner bears the economic risk of loss ("partner nonrecourse debt"). A liability is treated as partner nonrecourse debt to the extent a partner bears the economic risk of loss solely because the partner or a related person (within the meaning of the section 752 regulations) is the creditor or the guarantor and the debt is considered nonrecourse for purposes of section 1.1001-2.}

\textit{The regulations require the deductions attributable to partner nonrecourse debt to be allocated to the lending or guaranteeing partner. This is accomplished by requiring minimum gain calculations for each separate partner nonrecourse debt. If there is a net increase in the minimum gain attributable to a specific partner nonrecourse debt, the depreciation or cost recovery deductions generated by the property subject to the debt must be allocated to the lending or guaranteeing partner. If there are not enough depreciation or cost recovery deductions to cover the entire net increase in minimum gain, a pro rata portion of the partnership’s other loss items (except for depreciation or cost recovery deductions on property subject to a partnership nonrecourse liability) is used. A carryover rule applies if there are still not enough losses to cover the minimum gain increase.}

\textit{If there is a net decrease in the minimum gain attributable to a particular partner nonrecourse debt, a minimum gain chargeback requirement generally applies to the partner who was previously allocated the losses (or who received distributions) attributable to the debt. (See parts III and IV below). The minimum gain chargeback requirement is satisfied first with gain from the sale of the property subject to the partner nonrecourse debt and then by a pro rata portion of the partnership’s other income and gain items (except to the extent these items have been allocated to satisfy a partnership minimum gain chargeback requirement). Unsatisfied mini-}
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The definition of “partner nonrecourse debt” imposes these requirements:

- The liability must be a partnership liability.
- The liability must be nonrecourse for purposes of Treasury Regulations Section 1.1001-2.
- A partner or related person (within the meaning of Treasury Regulations Section 1.752-4(b)) must bear the economic risk of loss under Treasury Regulations Section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.\(^\text{890}\)

Identifying when a loan is a partnership liability, usually is not difficult. The problem begins in identifying whether the loan is nonrecourse for purposes of the Section 1001 Treasury Regulations. These rules determine the amount realized in sales subject to liabilities. Under these rules, “Except as provided in [two special rules in Treasury Regulations], the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”\(^\text{891}\) Among other things, these rules establish that “The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.”\(^\text{892}\) That language does not provide much illumination concerning when a liability is nonrecourse for purposes of Treasury Regulations Section 1.1001-2. The real tax question is whether, if the debt exceeds the fair market value of the security, a foreclosure will produce exclusively gain from a sale or exchange of the security or whether the foreclosure in part will produce cancellation of indebtedness income. The liability is nonrecourse for purposes of Treasury Regulations Section 1.1001-2 if the liability will produce only sale or exchange gain on a foreclosure.

No one is quite sure what it means to satisfy the second requirement – the liability must be nonrecourse for purposes of Treasury Regulations Section 1.1001-2. Traditionally, this has meant a liability that is nonrecourse in form

\footnotesize{\textit{mum gain chargeback requirements carry over to succeeding taxable years.}}


\(^\text{890}\) Treas. Reg. § 1.704-2(b)(4) (“Partner nonrecourse debt” or “partner nonrecourse liability” means any partnership liability to the extent the liability is nonrecourse for purposes of section 1.1001-2, and a partner or related person (within the meaning of section 1.752-4(b)) bears the economic risk of loss under section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor.”).

\(^\text{891}\) Treas. Reg. § 1.1001-2(a)(1).

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

– liability on a default is limited to foreclosing on the security. A debt that is recourse in form but is isolated in a single member limited liability company with a single principal asset might be treated as a nonrecourse liability under Treasury Regulations Section 1.1001-2. A debt that is recourse in form and that has full recourse to the assets of a limited liability company with many assets might not be treated as a nonrecourse debt for purposes of Section 1001. This liability does not differ much in substance from the full recourse liability of a corporation – full recourse to the assets of the entity but no recourse to the assets of the entity. The law has not clarified situations when a liability is unsecured but liability is limited to a single partnership asset or group of assets either by contract or by structure. The liability conceivably could be treated as nonrecourse liability under Treasury Regulations Section 1.1001-2.

You might question what happens with a liability that is nonrecourse in form, but when a partner has liability as a guarantor. Whether this liability will be treated as a nonrecourse liability under Treasury Regulations Section 1.1001-2, is not clear. If as a matter of substance a partner has liability for the debt, why should this liability be considered a nonrecourse debt? What greater recourse can the lender have than ability to reach the assets of a partner, albeit through a guarantee. The liability conceivably could be treated as a recourse liability under Treasury Regulations Section 1.1001-2 under the theory that the guarantee is functionally equivalent to a contingent capital contribution obligation, and that by virtue of the guarantee the lender should be treated as having recourse to the partnership debtor. Further clarification of the law may permit us better to understand what liabilities create partnership nonrecourse deductions. Indeed, it might be questioned whether any liability guaranteed by a person of substance should be treated as a nonrecourse obligation for purposes of Section 1001. The matter all the more could be questioned when the liability is guaranteed by one or more partners.

Whether a nonrecourse partner loan should be treated as a nonrecourse liability under Treasury Regulations Section 1.1001-2 is a matter of speculation. The loan perhaps could be treated as a recourse loan under Treasury Regulations Section 1.1001-2 on account of a partner directly bearing the risk of loss. The loan could be treated as a nonrecourse liability of the partnership under Section 1001. This issue needs to be further explored either in Treasury Regulations or in case law.

A better case perhaps can be made that a debt is a partner nonrecourse liability if the loan is made by an affiliate of a partner and the loan is nonrecourse in form. This debt may well be treated as a nonrecourse liability for purposes of Treasury Regulations Section 1.1001-2. Perhaps the loan from a partner affiliate is the best candidate for a partner nonrecourse loan. The nonrecourse loan to the partnership guaranteed by a partner affiliate is another candidate.
For the liability to be a partner nonrecourse liability, a partner or related person (within the meaning of Treasury Regulations Section 1.752-4(b)) must bear the economic risk of loss under Treasury Regulations Section 1.752-2 because, for example, the partner or related person is the creditor or a guarantor. This requires a risk of loss analysis. Pay particular attention to debt loaned by or guaranteed by a 10% or less partner and the special rule characterizing that debt. This is discussed above in the text at note 853.

Once you determine that indebtedness is partner nonrecourse debt, Treasury Regulations require that partnership losses, deductions, or Section 705(a)(2)(B) expenditures that are attributable to a particular partner nonrecourse liability (“partner nonrecourse deductions”) must be allocated to the partner who bears the economic risk of loss for the liability. This normally is the partner lender or the partner affiliate of the lender. A guarantor of the debt may bear the economic risk of loss for the liability. The partner nonrecourse deductions are allocated in accordance with the manner in which the various partners bear the economic risk of loss if more than one partner is the lender or an affiliate of the lender. Each portion of the partner nonrecourse liability, when partners bear the economic risk of loss for different portions of a partner nonrecourse liability, is treated as a separate partner nonrecourse liability. 893

The determination of the amount of partner nonrecourse deductions with respect to a partner nonrecourse debt is an annual determination. The amount of partner nonrecourse deductions with respect to a partner nonrecourse debt equals

- The net increase during the partnership’s taxable year in minimum gain attributable to the partner nonrecourse debt (“partner nonrecourse debt minimum gain”), reduced (but not below zero) by
- Proceeds of the liability distributed during the partnership’s taxable year to the partner bearing the economic risk of loss for the liability that are both attributable to the liability and allocable to an increase in the partner nonrecourse debt minimum gain. 894

Partner nonrecourse debt minimum gain is determined as the excess of partner nonrecourse debt over the “book” value of the security. 895

Partnership losses, deductions, and Section 705(a)(2)(B) expenditures are treated as partner nonrecourse deductions in this order:

894 Treas. Reg. § 1.704-2(i)(2).
895 Treas. Reg. § 1.704-2(i)(3).
First, depreciation or cost recovery deductions with respect to property that is subject to partner nonrecourse debt;

Then, if necessary, a pro rata portion of the partnership’s other deductions, losses, and Section 705(a)(2)(B) items.\textsuperscript{896}

Depreciation or cost recovery deductions (with respect to property that is subject to a partnership nonrecourse liability) are first treated as a partnership nonrecourse deduction and any excess is treated as a partner nonrecourse deduction.\textsuperscript{897}

---

136. Partner Nonrecourse Debt Minimum Gain Chargeback.

The allocation of partner nonrecourse deductions must be accompanied with a partner nonrecourse minimum gain chargeback that charges back prior allocations of partner nonrecourse deductions when the partner nonrecourse mini-

---

\textsuperscript{896} Treas. Reg. § 1.704-2(j)(1).
\textsuperscript{897} \textit{Id.}
some comments on how to compromise drafting partnership and llc agreements and some basic issues in drafting real estate partnership and llc agreements

minimum gain is reduced. Treasury Regulations prescribe these rules for determining a partner’s share of partner nonrecourse debt minimum gain.\footnote{Treas. Reg. § 1.704-2(i)(4) (“If during a partnership taxable year there is a net decrease in partner nonrecourse debt minimum gain, any partner with a share of that partner nonrecourse debt minimum gain (determined under paragraph (i)(5) of this section) as of the beginning of the year must be allocated items of income and gain for the year (and, if necessary, for succeeding years) equal to that partner’s share of the net decrease in the partner nonrecourse debt minimum gain. A partner’s share of the net decrease in partner nonrecourse debt minimum gain is determined in a manner consistent with the provisions of paragraph (g)(2) of this section. A partner is not subject to this minimum gain chargeback, however, to the extent the net decrease in partner nonrecourse debt minimum gain arises because the liability ceases to be partner nonrecourse debt due to a conversion, refinancing, or other change in the debt instrument that causes it to become partially or wholly a nonrecourse liability. The amount that would otherwise be subject to the partner nonrecourse debt minimum gain chargeback is added to the partner’s share of partnership minimum gain under paragraph (g)(3) of this section. In addition, rules consistent with the provisions of paragraphs (f)(2), (3), (4), and (5) of this section apply with respect to partner nonrecourse debt in appropriate circumstances. The determination of which items of partnership income and gain must be allocated pursuant to this paragraph (i)(4) is made in a manner that is consistent with the provisions of paragraph (f)(6) of this section.”).}

137. Exculpatory Deductions.

The nonrecourse deduction Treasury Regulations\footnote{Treas. Reg. § 1.704-2(i)(5) (“A partner’s share of partner nonrecourse debt minimum gain at the end of any partnership taxable year is determined in a manner consistent with the provisions of paragraphs (g)(1) and (g)(3) of this section with respect to each particular partner nonrecourse debt for which the partner bears the economic risk of loss. For purposes of section 1.704-1(b)(2)(ii)(d), a partner’s share of partner nonrecourse debt minimum gain is added to the limited dollar amount if any, of the deficit balance in the partner’s capital account that the partner is obligated to restore, and the partner is not otherwise considered to have a deficit restoration obligation as a result of bearing the economic risk of loss for any partner nonrecourse debt.”).} were drafted prior to the widespread use of limited liability companies. The increasing prevalence of limited liability companies has posed a difficult problem for drafters of partner-

\footnote{Treas. Reg. § 1.704-2.}
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ship agreements. Liabilities may be fully recourse to all of the assets of the limited liability company (or to a subset of the assets of a limited liability company but nonrecourse to the owners.) The liability may secured or unsecured. (The preamble to the nonrecourse deduction Treasury Regulations identifies: “A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability).”) This disregards the possibility that the liability may be unsecured on that the liability may be recourse to some but not all partnership assets (such as might happen in a series limited liability company or with a liability of a disregarded limited liability company. There is no apparent reason for limiting “exculpatory liabilities” to secured liabilities or liabilities that are recourse to the entire partnership as an entity.) These liabilities are treated as nonrecourse liabilities for purposes of the partnership rules for allocating liabilities among partners (Section 752). No partner bears the risk of loss.

These liabilities should not generate partnership minimum gain. The starting point in computing partnership minimum gain is this: “The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.”901 The exculpatory liability, however, should not be treated as a nonrecourse liability for purposes of Section 1001 (amount realized on sale). There is no minimum amount of gain that the partnership would realized if it disposed of the property subject to the liability for no consideration other than full satisfaction of the liability. The liability should be treated as a recourse liability for purposes of Section 1001. True nonrecourse deductions should depend on an increase in partnership minimum gain: “The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.”902

Consider allocating “exculpatory deductions” (deductions attributable to exculpatory liabilities) separately from allocations of other deductions and how else this may affect the manner in which you partnership agreement should be

---

drafted. A certain logic favors allocating exculpatory deductions in the same manner in which you allocate nonrecourse deductions.\textsuperscript{903}

Exculpatory liabilities do not fit neatly into the category of recourse liabilities for purposes of drafting recourse loss allocations. No partner bears the economic risk of loss. We cannot allocate exculpatory deductions to the partners who bear the economic risk of loss of these exculpatory liabilities. Furthermore, these liabilities technically are nonrecourse liabilities for purposes of Section 752.

These liabilities do not fall neatly into the category of nonrecourse liabilities that produce nonrecourse deductions. These liabilities are not secured (at least not necessarily secured) and are fully recourse to all partnership assets. These liabilities do not encumber partnership assets in the sense that “encumber” implies “secured by.” The minimum gain chargeback requires: “To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (‘partnership minimum gain’). An increase in partnership minimum gain is created by a decrease in the adjusted tax basis of property encumbered by a nonrecourse liability below the amount of that liability and by a partnership nonrecourse borrowing that exceeds the adjusted tax basis of the property encumbered by the borrowing. Partnership minimum gain decreases as reductions occur in the amount by which the nonrecourse liability exceeds the adjusted tax basis of the property encumbered by the liability. . . .”\textsuperscript{904} The Treasury Regulation presumably would be clearer if “encumber” meant something other than “secured by.”

Nonrecourse deductions are defined in terms of the increase in minimum gain during the taxable year. Exculpatory liabilities do not clearly produce minimum gain. The Treasury Regulations define the change in minimum gain: “The amount of partnership minimum gain is determined by first computing for each partnership nonrecourse liability any gain the partnership would realize if it disposed of the property subject to that liability for no consideration other than full satisfaction of the liability, and then aggregating the separately computed gains.”\textsuperscript{905} Exculpatory liabilities that are full recourse to the partnership should not be nonrecourse deductions for purposes of Section 1001. If the property is presumed to have a basis and fair market value equal to its “book” value, the part-

\textsuperscript{903} See text accompanying note 540 concerning proposed language for allocating exculpatory deductions.

\textsuperscript{904} Treas. Reg. § 1.704-2(b)(2).

\textsuperscript{905} Treas. Reg. § 1.704-2(d)(1).
Exculpatory liabilities are terribly confusing to most draftsmen of partnership agreements. Exculpatory liabilities and exculpatory deductions are not clearly addressed by the current Treasury Regulations on partnership allocations. You may “treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).” Partnership case law, statutory law and administrative law are not clear on how much liberality this statement in a preamble to Treasury Regulations on nonrecourse deductions creates.

---

908 The preamble to the final regulations on allocating partnership nonrecourse deductions states:

**B. Minimum Gain Calculations For Exculpatory Liabilities.**

A partnership may have a liability that is not secured by any specific property and that is recourse to the partnership as an entity, but explicitly not recourse to any partner (exculpatory liability). Section 1.704-2(b)(3) of the final regulations defines nonrecourse liability by referring to the definition of nonrecourse liability in the regulations under section 752. Under that definition, an exculpatory liability is a nonrecourse liability. The application of the nonrecourse debt rules of section 1.704-2 – more specifically, the calculation of minimum gain – may be difficult in the case of an exculpatory liability, however, because the liability is not secured by specific property and the bases of partnership properties that can be reached to the lender in the case of an exculpatory liability may fluctuate greatly. Section 1.704-2 does not prescribe precise rules addressing the allocation of income and loss attributable to exculpatory liabilities. Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b). Commentators have requested that the treatment of allocations attributable to exculpatory liabilities under the nonrecourse debt rules be clarified. The Service and the Treasury solicit further suggestions on the appropriate treatment of allocations attributable to these liabilities. Suggestions should take into account the practical concerns of partnerships as well as the Service’s concerns about the proper allocation of loss and gain items attributable to these liabilities.

ity may be limited to the guidelines that would apply under the nonrecourse deduction rules.\footnote{909}{Treas. Reg. § 1.704-2 (especially paragraph (e)).}

The IRS has not shown enthusiasm for revisiting the issue of “exculpatory liabilities” or “exculpatory deductions.” Perhaps the IRS does not even understand exculpatory deductions well. Exculpatory liabilities are common in the context of limited liability companies, so that rules for allocating exculpatory deductions should be a big issue. The IRS seems to have avoided this issue since this issue was identified. Recourse debt of a limited liability company (with full recourse to the limited liability company’s assets) may not be nonrecourse liabilities for purposes of Section 1001, which is used to determine minimum gain. No partner bears the economic risk of loss of exculpatory liabilities. Deductions attributable to exculpatory liabilities consequently cannot be allocated in accordance with the manner in which partners bear the economic risk of loss of the underlying exculpatory liabilities.

The IRS seems to have missed a fundamental issue. Exculpatory liabilities may not produce minimum gain at all. This is a fundamental flaw in the IRS’ analysis. Minimum gain – or partnership minimum gain, at least – is defined in Treasury Regulations: “To the extent a nonrecourse liability exceeds the adjusted tax basis of the partnership property it encumbers, a disposition of that property will generate gain that at least equals that excess (‘partnership minimum gain’).”\footnote{910}{Treas. Reg. § 1.704-2(b)(2).} This analysis implicitly references Section 1001 on amount realized. Section 1001 Treasury Regulations state: “The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.”\footnote{911}{Treas. Reg. § 1.1001-2(a)(4)(i).} History suggests that minimum gain was intended to be parallel to minimum gain from liabilities that are nonrecourse for purposes of Section 1001.

Considerable doubt exists that the common exculpatory liability is nonrecourse for purposes of Section 1001 or produces “nonrecourse deductions.” The exculpatory liability is unsecured and is full recourse to all partnership assets. It is doubtful that a liability that is full recourse to the assets of an entity should be treated as a nonrecourse liability under Section 1001. A liability that by its terms is full recourse to the assets of a special purpose limited liability company with a single asset perhaps would be treated as “nonrecourse” for purposes of Section 1001, but that is a matter for the future to resolve. However that is resolved, it is doubtful that a liability that is full recourse to the assets of a partnership with a number of assets, but nonrecourse to the partners, is a nonrecourse liability under Section 1001. An exculpatory liability is unsecured. Question whether this excul-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Exculpatory liability “encumbers” any property at all. The exculpatory liability must encumber partnership property to generate partnership minimum gain. The exculpatory liability may encumber partnership property in the sense that the exculpatory liability burdens the partnership property. The exculpatory liability, however, does not encumber partnership property in the manner in which a secured nonrecourse liability encumbers partnership property.

Few partnership agreements have special provisions concerning deductions attributable to exculpatory liabilities. These deductions perhaps are included in either Nonrecourse Deductions or Net Losses. A good case can be made that deductions attributable to exculpatory liabilities are regular recourse deductions and includable in Net Profits and Net Losses unless the partnership agreement says otherwise (which is should). No partner bears the economic risk of loss that these deductions may well not be reversed through a minimum gain chargeback.  

The language in the preamble suggests the possibility of creative allocations of exculpatory deductions. The preamble to nonrecourse deduction Treasury Regulations advises: “Taxpayers, therefore, are left to treat allocations attributable to these liabilities in a manner that reasonably reflects the principles of section 704(b).” This provides desperately inadequate guidance concerning how exculpatory deductions should be allocated.

912 Since exculpatory liabilities are nonrecourse to the members, they come within the definition of nonrecourse liabilities under I.R.C. § 752 and (by extension) I.R.C. § 704. Exculpatory deductions might be allocated in accordance with the normal nonrecourse deduction rules. The problem is that exculpatory deductions do not generate minimum gain and therefore do not generate potential minimum gain chargeback. A possible solution would be to treat the exculpatory liabilities as nonrecourse liabilities that are secured by all of the LLC's assets. That would create a minimum gain if the property were disposed of in exchange for the exculpatory liabilities. The fiction perhaps should treat a cancellation of all or a portion of the exculpatory liability as creating minimum gain. Where a member (or a related party) lends money to a limited liability company, the partnership agreement could specially allocate the deductions attributable to those loans to the member. Since the loans are not secured by the assets, the partnership agreement could allocate the first disposition income (or cancellation of indebtedness income) to that member to offset the loss allocation. Since the loan is not secured, the offsetting income would come from Net Profits rather than from the traditional minimum gain chargeback.

We might try to cobble together rules for allocating exculpatory deductions from the nonrecourse deduction Treasury Regulations. Perhaps allocations of exculpatory deductions should meet the standards of the rules for allocation of nonrecourse deductions. This seems to be the best approach (with appropriate modification to the nonrecourse deduction rules). A minimum gain chargeback, however, will not work for the reversal of exculpatory deductions if exculpatory deductions do not generate minimum gain. Consider drafting something similar to a minimum gain chargeback to allocate income to the partner receiving prior allocations of exculpatory deductions when the exculpatory liabilities are reduced or when the amount of exculpatory liabilities over “book” value of property that may be reached by the creditor for the exculpatory liabilities, is otherwise reduced. The loose language in the preamble suggests that the IRS will liberally accept good faith attempts to allocate exculpatory deductions. Considering the magnitude of the problem, the IRS should make exculpatory deductions a high priority item for clarifying Treasury Regulations. Considering the prevalence of exculpatory deductions and exculpatory liabilities in limited liability companies, this is an issue that every draftsman of a limited liability company operating agreement should address.

Perhaps your partnership agreement may just treat exculpatory deductions in the computation of Net Profits and Net Losses. This creates the possibility that allocations of exculpatory deductions may change annually with shifts in the allocation of Net Profits or Net Losses. While this scheme is plausible, the theoretical underpinnings of a scheme under which allocations of exculpatory deductions should shift annually with the manner in which partners bear the economic risk of loss of recourse deductions, seems lean.

A full discussion of exculpatory liabilities and allocation of exculpatory deductions is outside of the scope of this Article. This would be a good issue for the IRS to investigate. Converting a partnership agreement to account for exculpatory deductions requires reanalysis of practically all allocation provisions.

Identify clearly in your partnership agreement what provision allocates exculpatory deductions. Regulations provide substantial flexibility.

138. Section 704(c)(1)(A) and “Book” Income.

This Article has referred frequently to “book” income in adjusting capital accounts and as the object of partnership allocations. Accountants will translate “book” income and loss into allocations of taxable income and loss so that the partnership accountants can complete partnership tax returns and partners can pay
their taxes. The tax provision that converts “book” income and loss into taxable income and loss is the tax provision that applies to contributed property with a “book”-tax disparity (Section 704(c)(1)(A)).

The rules governing allocation of tax income and gain items when “book”-tax disparities exist (Section 704(c)(1)(A)) can be summarized for allocating gain on a contributed asset under what is referred to as the “traditional” method:

- Identify the contributor of the specific property and the noncontributing partners. Note that allocation of tax income and gain items when “book”-tax disparities exist requires asset-by-asset computations.
- Calculate the tax gain on sale from the contributed asset.
- Calculate the “book” gain on sale of the contributed asset. Where this is combined in an item like “Net Profits,” determine how Net Profits are allocated and use this to determine how the “book” gain on sale of the contributed asset is allocated.

---

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Allocate the “book” gain on the sale of the contributed asset in accordance with the partnership agreement. This “book” gain may be allocated in part under the minimum gain chargeback, under the allocation of Net Profits, or under the allocation of net gain from sale. Identify how the “book” gain with respect to the contributed asset was allocated among the partners.

- Identify how much of the “book” gain from the contributed asset is allocated to each of the partners.

- Isolate the noncontributing partners.

- Take the tax gain from sale of the contributed asset and allocate an amount of that tax gain from sale of the contributed asset to each of the noncontributing partners (to the extent possible) in an amount equal to each partner’s share of “book” gain from sale of the contributed asset. There may not be enough tax gain from sale of the contributed asset to allocate to each noncontributing partner an amount of tax gain from sale of the contributed asset equal to “book” gain from sale of the contributed asset. Allocate the available tax gain from sale of the contributed asset pro rata by each noncontributing partner’s share of “book” gain from sale of the contributed asset.

- Allocate any remaining tax gain from sale of the contributed asset (if any) to the contributing partner, regardless of the contributing partner’s share of “book” gain from sale of the contributed asset. This concludes the process.

This methodology is applied on an asset-by-asset basis for each contributed asset. Each partner should be treated as either a contributing partner or a noncontributing partner with respect to each contributed asset. Different tenancy-in-common interests in a single asset likely are treated as separate assets for this purpose, although Treasury Regulations are not explicit on this point. Each partner is treated as a contributing partner or a noncontributing partner with respect to each tenancy-in-common interest. Each tenancy-in-common interest has a separate fair market value and a separate adjusted tax basis (or “book” value).

Essentially the same methodology can be used to compute tax depreciation under the “traditional” method. The rules governing allocation of tax loss items when “book”-tax disparities exist (Section 704(c)(1)(A)) can be summarized for allocating depreciation on a contributed asset under what is referred to as the “traditional” method:

- Identify the contributor of the specific property and the noncontributing partners.

- Calculate the tax depreciation of the contributed asset.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Calculate the “book” depreciation of the contributed asset.
- Allocate the “book” depreciation of the contributed asset in accordance with the partnership agreement. This “book” depreciation may be allocated in part under the allocation of Net Profits, the allocation of Net Losses, the allocation of Nonrecourse Deductions, the allocation of Partner Nonrecourse Deductions, or under a special allocation of depreciation. Identify how the “book” depreciation with respect to the contributed asset was allocated among the partners.
- Identify how much of the “book” depreciation from the contributed asset is allocated to each of the partners.
- Isolate the noncontributing partners.
- Take the tax depreciation of the contributed asset and allocate an amount of that tax depreciation of the contributed asset to each of the noncontributing partners (to the extent possible) in an amount equal to each partner’s share of “book” depreciation of the contributed asset. There may not be enough tax depreciation of the contributed asset to allocate to each noncontributing partner an amount of tax depreciation of the contributed asset equal to “book” depreciation of the contributed asset. Allocate the available tax depreciation of the contributed asset pro rata by each noncontributing partner’s share of “book” depreciation of the contributed asset.
- Allocate any remaining tax depreciation of the contributed asset (if any) to the contributing partner, regardless of the contributing partner’s share of “book” depreciation of the contributed asset. This concludes the process.

The amount of “book” depreciation or “book” gain on sale (as the case may be) allocable to noncontributing partners may exceed the total amount of tax depreciation or tax gain on sale (as the case may be) of the partnership. This triggers the application of the “ceiling” rule. The traditional method does not permit the partnership to allocate to noncontributing partners more tax items than the partnership has, regardless of the “book” items allocable to the partners. The partnership in these cases will allocate the entire available tax item pro rata to the noncontributing partners. That is all that the partnership can allocate under the traditional method on account of the “ceiling” rule.

The IRS has designed two methods of applying the tax rules with respect to contributed property that can be used to overcome the “ceiling” rule. One of these methods permits special curative allocations of tax items to overcome the “ceiling” rule. Another method creates special tax items to overcome the “ceiling” rule. These two methods – the traditional method with curative allocations and the
remedial method – otherwise are outside of the scope of this article. Be careful to specify in your partnership agreement which method your partnership will use. The traditional method usually is the method most favorable to the contributor.

A partnership is permitted to revalue its assets on specified events. When the partnership does revalue its assets, afterwards the partnership applies the rules governing tax items with respect to contributed property (Section 704(c)(1)(A)) to deal with the “book”-tax disparity. Each partner who is a partner at the time of the revaluation is treated as a contributor with respect to a tenancy-in-common interest in each asset that is revalued.

Consider another related provision when a partner contributes loss property to your partnership.915 This provision technically applies when a partner contributes property with a latent “built-in loss.” “Built in loss” means the excess of (i) the adjusted basis of the property (determined without regard to the rule that states that “except as provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership shall be treated as being equal to its fair market value at the time of contribution”) over (ii) its fair market value (at the time of contribution). A contributed property may have built-in loss. The built-in loss is taken into account only in determining the amount of items allocated to the contributing partner. The noncontributing partners do not share in this built-in loss. Except as otherwise provided in regulations, in determining the amount of items allocated to other partners, the basis of the contributed property in the hands of the partnership is treated as being equal to its fair market value (at the time of contribution). This provision does not provide for a minimum amount of built-in loss in order to apply. It will apply even if the built-in loss is small. This provision can be complicated in operation.916

139. Traditional Method under Section 704(c)(1)(A).

Many partnerships are formed with contributions of property (“contributed property”) by a partner. A special tax provision (Section 704(c)(1)(A)) applies to


916 See, for example, Lukasz Rachuba, “New Issues With Partnership Built-in Loss Property,” 107 TAX NOTES 1569 (June 20, 2005). It is not clear whether I.R.C. § 704(c)(1)(C) will apply to built-in loss that is created by a revaluation of partnership assets. There also is uncertainty how this provision will apply on a technical termination of a partnership and whether that technical termination can create built-in loss subject to this provision.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

govern how future depreciation and future gain or loss on sale are allocated among the partners of a partnership. Many accountants and attorneys are challenged by the application of this provision (notwithstanding its centrality to the preparation of many partnership tax returns).

This section discusses the traditional method – one of three available methods under this tax provision. Tax preparers typically assume that they have facility with the traditional method. Experience, however, shows that many professionals – whether accountants or attorneys – are challenged by the mathematics of the traditional method. This traditional method is applied by most partnerships when applying Section 704(c)(1)(A).

This Article discusses the basic rules under the traditional method and sets forth a simple, consistent method for making Section 704(c)(1)(A) allocations among the partners of a partnership. Section 704(c)(1)(A) can be properly understood only in terms of numbers. The professional who wants to apply Section 704(c)(1)(A) should have a calculator or a computer readily available.\(^917\)

This discussion is limited to the application of the traditional method to contributed property. It does not discuss the traditional method with curative allocations or the remedial method. Both the traditional method with curative allocations and the remedial allocation method are available under Section 704(c)(1)(A). It does not discuss the special aggregation rules that are limited to securities partnerships nor the issues of using the traditional method in connection with partnership revaluations of their assets.

The language of Section 704(c)(1)(A) seems simple enough.

\((c)\) Contributed property

\((1)\) In general. Under regulations prescribed by the Secretary -

\((A)\) income, gain, loss, and deduction with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution, . . .

We start with contributed property. Section 704(c)(1)(A) applies only with respect to contributed property – property contributed to the capital of a partnership by a partner. (Principles of Section 704(c)(1)(A) can apply to a revaluation of

\(^917\) Most of the material in this Article interprets the Treasury Regulations governing Section 704(c)(1)(A) allocations under the traditional method. This material is found in Treas. Reg. § 1.704-1(b).
partnership property.) Section 704(c)(1)(A) applies only to tax allocations of income, gain, loss, and deduction – only to tax allocations of income, gain, loss, and deduction with respect to contributed property (at least, when the traditional method is applied). This provision does not affect allocations of “book” income or “book” losses. It does not affect allocations of tax items with respect to noncontributed property.

The “book” value of contributed property is the value used for purposes of maintaining capital accounts under the Section 704(b) Treasury Regulations\(^{918}\) – starting with fair market value of the property at the date of contribution to the partnership. “Book” value is subsequently adjusted by “book” depreciation and by other similar adjustments. These adjustments follow the capital account adjustment rules under Section 704. “Book” income and loss (and other tax items) are income and loss computed in accordance with federal income tax principles, substituting “book” values for adjusted tax basis. The computation of “book” income and loss (and other tax items) otherwise follows tax rules. “Book” income and loss are the income and loss that adjust capital accounts that are maintained in accordance with the Section 704(b) Treasury Regulations.

Section 704(c)(1)(A) requires that all items of tax income, gain, loss, and deduction with respect to contributed property be shared among the partners so as to take account of the variation between the adjusted tax basis of the property to the partnership and its fair market value at the time of contribution (“book-tax disparity”). The problem is how to share income, gain, loss, and deduction with respect to contributed property so as to take account of the “book”-tax disparity reasonably.

Contributed property subject to Section 704(c)(1)(A) is referred to as “Section 704(c) property.” Contributed property is “Section 704(c) property” if its “book” value differs from the contributing partner’s adjusted tax basis.\(^{919}\) This determination is made at the time of contribution of the property to the partnership.\(^{920}\)

a. Built-in Gain and Loss.

Section 704(c)(1)(A) operates on built-in gain or built-in loss in contributed property. Contributed property that does not have built-in gain or built-in loss is not subject to the rules of Section 704(c)(1)(A) (even though this property may have been contributed to the partnership by a partner). (The property may still be

\(^{918}\) See Treas. Reg. § 1.704-1(b)(2)(iv).

\(^{919}\) Treas. Reg. § 1.704-3(a)(3)(i).

\(^{920}\) Id.
subject to rules based on the rules of Section 704(c)(1)(A) if the property has been subject to a revaluation.)

Built-in gain on Section 704(c) property at the time of contribution is the excess of—

- The property’s “book” value over
- The contributing partner’s adjusted tax basis upon contribution.  

This chart shows simple computations of initial built-in gain where contributed property has the indicated fair market value and adjusted tax basis at time of contribution:

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
<th>Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$20,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>$100,000</td>
<td>$40,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>$100,000</td>
<td>$60,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>$100,000</td>
<td>$80,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>$100,000</td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td>$500,000</td>
<td>$100,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>$500,000</td>
<td>$200,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>$500,000</td>
<td>$300,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>$500,000</td>
<td>$400,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>$500,000</td>
<td>$500,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

Built-in gain in the contributed Section 704(c) property is reduced after contribution by adjustments that decrease the difference between the property’s “book” value and its adjusted tax basis. Depreciation or cost recovery, for example, reduces built-in gain. Built-in gain should be eliminated by the end of the property’s depreciation life. Section 704(c)(1)(A) will have no effect on the partners after the end of the property’s depreciation life.

Example 1. Bill and Ulysses form Springfield Partners. Bill contributes improvements on leased land. The fair market value of the improvements at time of contribution is $500,000. The adjusted tax basis of the improvements at time of contribution is $300,000. Ulysses contributes $500,000 in cash. The remaining life of the improvements is 10 years. This table shows the computation of “book” cost recovery and built-in gain:

---

922 Id.
923 Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Adjusted Tax Basis</th>
<th>Tax Depreciation</th>
<th>Beginning “Book” Value</th>
<th>“Book” Depreciation</th>
<th>Ending Built-in Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$300,000</td>
<td></td>
<td>$500,000</td>
<td>$50,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>1</td>
<td>$300,000</td>
<td>$30,000</td>
<td>$500,000</td>
<td>$50,000</td>
<td>$180,000</td>
</tr>
<tr>
<td>2</td>
<td>$270,000</td>
<td>$30,000</td>
<td>$450,000</td>
<td>$50,000</td>
<td>$160,000</td>
</tr>
<tr>
<td>3</td>
<td>$240,000</td>
<td>$30,000</td>
<td>$400,000</td>
<td>$50,000</td>
<td>$140,000</td>
</tr>
<tr>
<td>4</td>
<td>$210,000</td>
<td>$30,000</td>
<td>$350,000</td>
<td>$50,000</td>
<td>$120,000</td>
</tr>
<tr>
<td>5</td>
<td>$180,000</td>
<td>$30,000</td>
<td>$300,000</td>
<td>$50,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>6</td>
<td>$150,000</td>
<td>$30,000</td>
<td>$250,000</td>
<td>$50,000</td>
<td>$80,000</td>
</tr>
<tr>
<td>7</td>
<td>$120,000</td>
<td>$30,000</td>
<td>$200,000</td>
<td>$50,000</td>
<td>$60,000</td>
</tr>
<tr>
<td>8</td>
<td>$90,000</td>
<td>$30,000</td>
<td>$150,000</td>
<td>$50,000</td>
<td>$40,000</td>
</tr>
<tr>
<td>9</td>
<td>$60,000</td>
<td>$30,000</td>
<td>$100,000</td>
<td>$50,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>10</td>
<td>$30,000</td>
<td>$30,000</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$0</td>
</tr>
<tr>
<td>11</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

Built-in loss on Section 704(c) property is the excess of –

- The contributing partner’s adjusted tax basis over
- The property’s “book” value upon contribution.924

This chart shows simple computations of initial built-in loss where contributed property has the indicated fair market value and adjusted tax basis at time of contribution:

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Adjusted Tax Basis</th>
<th>Built-in Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>$100,000</td>
<td>$200,000</td>
<td>($100,000)</td>
</tr>
<tr>
<td>$100,000</td>
<td>$180,000</td>
<td>($80,000)</td>
</tr>
<tr>
<td>$100,000</td>
<td>$160,000</td>
<td>($60,000)</td>
</tr>
<tr>
<td>$100,000</td>
<td>$140,000</td>
<td>($40,000)</td>
</tr>
<tr>
<td>$100,000</td>
<td>$120,000</td>
<td>($20,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$1,000,000</td>
<td>($500,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$900,000</td>
<td>($400,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$800,000</td>
<td>($300,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$700,000</td>
<td>($200,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$600,000</td>
<td>($100,000)</td>
</tr>
<tr>
<td>$500,000</td>
<td>$500,000</td>
<td>$0</td>
</tr>
</tbody>
</table>

924 Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Built-in loss in the contributed Section 704(c) property is reduced after
contribution by decreases in the difference between the property’s adjusted tax
basis and “book” value (most typically on account of depreciation or additions to
adjusted tax basis).  

Built-in loss similarly should be eliminated by the end of the property’s
depreciation life. Section 704(c)(1)(A) will cease to apply when depreciation
causes the “book” value of contributed property and the adjusted tax basis of the
contributed property to converge to the same value. This will happen at the end of
the useful life of the property.

<table>
<thead>
<tr>
<th>Year</th>
<th>Beginning Adjusted Tax Basis</th>
<th>Tax Depreciation</th>
<th>Beginning “Book” Value</th>
<th>“Book” Depreciation</th>
<th>Ending Built-in Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$500,000</td>
<td></td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>1</td>
<td>$500,000</td>
<td>$50,000</td>
<td>$1,000,000</td>
<td>$100,000</td>
<td>$450,000</td>
</tr>
<tr>
<td>2</td>
<td>$450,000</td>
<td>$50,000</td>
<td>$900,000</td>
<td>$100,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>3</td>
<td>$400,000</td>
<td>$50,000</td>
<td>$800,000</td>
<td>$100,000</td>
<td>$350,000</td>
</tr>
<tr>
<td>4</td>
<td>$350,000</td>
<td>$50,000</td>
<td>$700,000</td>
<td>$100,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>5</td>
<td>$300,000</td>
<td>$50,000</td>
<td>$600,000</td>
<td>$100,000</td>
<td>$250,000</td>
</tr>
<tr>
<td>6</td>
<td>$250,000</td>
<td>$50,000</td>
<td>$500,000</td>
<td>$100,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>7</td>
<td>$200,000</td>
<td>$50,000</td>
<td>$400,000</td>
<td>$100,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>8</td>
<td>$150,000</td>
<td>$50,000</td>
<td>$300,000</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>9</td>
<td>$100,000</td>
<td>$50,000</td>
<td>$200,000</td>
<td>$100,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>10</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$100,000</td>
<td>$100,000</td>
<td>$0</td>
</tr>
<tr>
<td>11</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
</tbody>
</table>

b. Fair Market Value.

Treasury Regulations concerning Section 704(c)(1)(A) do not discuss how
fair market value is determined. The Treasury Regulations strongly support the
proposition that fair market value under Section 704(c)(1)(A) is parallel to the
concept of fair market value under the Section 704(b) Treasury Regulations.  

---

925 Id.
926 Treas. Reg. § 1.704-3(a)(3)(i) (“Property contributed to a partnership is
section 704(c) property if at the time of contribution its book value differs from
the contributing partner’s adjusted tax basis. For purposes of this section, book
value is determined as contemplated by section 1.704-1(b). Therefore, book value
is equal to fair market value at the time of contribution and is subsequently ad-
justed for cost recovery and other events that affect the basis of the property. For a
partnership that maintains capital accounts in accordance with section 1.704-
(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Treasury Regulations under Section 704(b) provide that “fair market value” is:

(h) Determinations of fair market value. For purposes of this paragraph (b)(2)(iv), the fair market value assigned to property contributed to a partnership, property distributed by a partnership, or property otherwise revalued by a partnership, will be regarded as correct, provided that (1) such value is reasonably agreed to among the partners in arm’s-length negotiations, and (2) the partners have sufficiently adverse interests. If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv). Valuation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis, except to the extent the regulations under section 704(c) permit otherwise.\(^{927}\)

This convention regarding agreed fair market value is not a presumption. This convention for accepting agreed fair market values apparently may not be rebutted. The agreed fair market value meeting this convention for accepting agreed fair market values “will be regarded as correct.” It appears that neither the IRS nor a partner is permitted to dispute the correctness of an agreed fair market value that qualifies under this convention for accepting agreed fair market values.

The same convention for accepting agreed fair market values should be used across the provisions of Section 704. Fair market value is critical to the application of both Section 704(b) and Section 704(c)(1)(A). Accurate fair market value is critical to the application of both provisions. Both Section 704(b) and Section 704(c)(1)(A) are part of the same machinery governing how partnership income and loss are allocated among partners. The Treasury Regulations strongly support the conclusion that the convention for accepting agreed fair market values under Section 704(b) also applies under Section 704(c)(1)(A).\(^{928}\)

\(^{927}\) Treas. Reg. § 1.704-3(a)(3)(i) (quoted at note 926).

\(^{928}\) Treas. Reg. § 1.704-3(a)(3)(i) (quoted at note 926).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Most people imagine that whatever value the partners use in their partnership agreement will control for all purposes. That is not what Treasury Regulations say. The convention for accepting the partners’ agreed fair market value as correct is subject to important requirements that must be satisfied for the convention to apply. The value must be “reasonably agreed to among the partners in arm’s-length negotiations.”

The convention for accepting agreed fair market values is important. The tax system in theory will assign a unique number as the fair market value of an asset. The partnership cannot properly apply the rules of either Section 704(b) or Section 704(c)(1)(A) without knowing the correct fair market values of contributed assets. Few issues in the tax law are more contested than what the correct fair market value of an asset is. Substantial subjectivity usually accompanies the art and science of appraisal. The market often assigns a range of market values to an asset. Different appraisers typically would assign different values. The value assigned by the partners must be within the range of reasonableness to meet the convention for accepting agreed fair market values. Partnership allocations might be at risk until values are definitely determined by a court in the absence of something that gives the partnership comfort that agreed values will be accepted.

The convention for accepting agreed fair market values is flexible, but not infinitely flexible. Several important components of the convention for accepting agreed fair market values are important. Partners are permitted to agree on fair market values. These agreed values “will be regarded as correct,” but only under specified circumstances. Treasury Regulations specify that the agreed value will control only if these conditions are satisfied:

- The value must be reasonably agreed to.
- The value must be reasonably agreed to among the partners.
- The value must be reached in arm’s-length negotiations.
- The partners must have sufficiently adverse interests.
- Valuation must be on a property-by-property basis, except to the extent otherwise provided by Treasury Regulations.

The agreement must be “reasonably agreed to.” The Treasury Regulations do not say that the value must be reasonable. The language used in the Treasury Regulations is curious. Should we infer that “reasonably agreed to” means something different from “reasonable”? That is a lingering possibility. An astute ob-

---

930 Id.
server could point out that the use of “such value is reasonably agreed to” may differ substantially from “the value is reasonable.” What distinction was intended nevertheless is obscure. The language of the Treasury Regulations may have been clumsy and may have created a subtle linguistic nuance that was not intended.

My inference is that the Treasury Regulations require that the agreed value must be reasonable; the nuance in language merely was inadvertent; the Treasury Regulations impose a requirement on the result and were not intended particularly to stress that the process through which they reached the agreement must be reasonable. The fair market value assigned in the partnership agreement must be within the range of reasonable estimates of the value of a contributed asset to qualify under the convention for accepting agreed fair market values. We do not know precisely what “reasonably agreed to” means. One has the sense that the fair market value ascribed to the asset must be a value that might be reached by a reasonable appraiser using reasonable methods – or perhaps a value reasonably ascribed to the asset by a reasonable partner.

The convention for accepting agreed fair market values requires that the value must be reasonably agreed to among the partners. This agreement must be reached in arm’s-length negotiations. Investment opportunities in many partnerships often are provided on a take it or leave it business to investors. Partners are not involved in negotiations over the values of contributed property in these partnerships. The values assigned by the partners in these circumstances may not qualify for the presumption of correctness. Many partners simply agree that that fair market value of contributed assets (or certain classes of contributed assets) will be equal to the adjusted tax bases or the GAAP values of these assets. These agreements may not be considered a reasonable valuation under the Treasury Regulations and may not qualify for the convention for accepting agreed fair market values.

The Treasury Regulations apply the fair market value determination on an item by item basis. Negotiations often lavish time on determining the fair market value of the aggregate contribution of each partner. Little attention often is given to the allocation of this aggregate fair market value among the various assets contributed by a partner. The fair market value agreement may not meet the requirements for the convention for accepting agreed fair market values. The values of individual assets may not have been “reasonably agreed to among the partners in arm’s-length negotiations” and the partners may not “have sufficiently ad-

---

931 Treas. Reg. § 1.704-3(a)(2).
verse interests” with respect to the allocation of the aggregate value among assets contributed by the partner.932

We can only speculate on how much a court or the IRS would insist on affirmative evidence that values (including individual asset values) were subject to arm’s-length negotiations among the partners. Determinations made by the IRS normally are presumed to be correct. The taxpayer has the burden of proof in overcoming determinations by the IRS. The taxpayer thus has the burden of proof in showing that the fair market value agreed to by the parties was “reasonably agreed to among the partners in arm’s-length negotiations.” The taxpayer may have the burden of showing that these arm’s-length negotiations actually took place. One may imagine a taxpayer producing videotapes of negotiations in which adverse partners are shouting, waving their arms, and storming about a conference room.

Partners sometimes simply agree that appraised values of contributed property will control partnership economics. Little or no true negotiations concerning values may occur. All of the work is done by the appraisers. Whether this will meet the convention for “reasonably agreed to among the partners in arm’s-length negotiations” is not clear. It would be unfortunate if the appraised values were not permitted to control in these circumstances, unless those values were outside of the range of reasonableness.

The reasonable agreement of the partners controls only if the partners have sufficiently adverse interests. Treasury Regulations do not provide further texture to what it means for “the partners [to] have sufficiently adverse interests.” Treasury Regulations fail to clarify as to what the interests must be to be sufficiently adverse. One reasonably could ask: sufficiently adverse as to what? The sensible interpretation is that the interests of the partners must be sufficiently adverse as to fair market values to give reality to the negotiations. This still leaves open the situation in which all partners might pump up the fair market values of all contributions. Whether sufficient adversity exists in this situation is not clear.

Several situations quickly come to mind where sufficient adversity may not be present. It may be difficult to show sufficient adversity in the case of a partnership among commonly controlled entities. It may also be difficult to show sufficient adversity in the case of a partnership among family members, particularly when the partnership arrangement is dominated by parents or grandparents. It may be difficult to show sufficient adversity in the case of a partnership between an employee and his employees.

Partnership advisors perhaps should consider documenting negotiations among adverse partners with videotapes of negotiations in which adverse partners are shouting, waving their arms, and storming about a conference room. This might create new employment opportunities for videographers.

Partners should value contributed property on a property-by-property basis. Partnership agreements frequently aggregate the fair market values of a group of assets contributed to the partnership by a partner. For example, partnership agreements frequently assign a single fair market value to a combined contribution of land and building. This does not technically meet the requirement of a separate value for each asset. Aggregated values may not meet the requirement that “[v]aluation of property contributed to the partnership, distributed by the partnership, or otherwise revalued by the partnership shall be on a property-by-property basis.”

Failure of the partnership agreement to set forth property-by-property values may invalidate the agreement of the partners and may require the partnership to rely on the traditional willing buyer-willing seller standard of fair market value. At the least, failure of the partnership agreement to set forth property by property values will inconvenience the partnership in seeking to apply the mathematics of Section 704(c)(1)(A).

Many partnership agreements should not qualify for the convention for respecting agreed fair market values of partnership assets. The Treasury Regulations approach is curious. They state: “If, however, these conditions are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv).” We might imagine that an unreasonable agreement on fair market values, or an agreement on fair market values not “reasonably agreed to among the partners in arm’s-length negotiations” or not reached among “partners [who] have sufficiently adverse interests” should be rejected altogether and should not be of any probative value. The Treasury Regulations say that “If, however, these conditions [to accepting the agreed fair market value as controlling] are not satisfied and the value assigned to such property is overstated or understated (by more than an insignificant amount), the capital accounts of the partners...

---

933 Treas. Reg. § 1.704-1(b)(2)(iv)(h). See also, Treas. Reg. § 1.704-3(a)(2) (“Therefore, in determining whether there is a disparity between adjusted tax basis and fair market value, the built-in gains and built-in losses on items of contributed property cannot be aggregated.”).
934 See text at note 937.
will not be considered to be determined and maintained in accordance with the rules of this paragraph (b)(2)(iv).”\textsuperscript{936}

One might infer that (even if the conditions for respecting the agreed fair market value are not otherwise met) the agreed fair market value will be respected if it does not overstate or understate the value by more than an insignificant amount. This suggests that total adherence to the conditions for respecting the agreed fair market value is not absolutely required, just as long as the agreed fair market value is not too far off. The Treasury Regulations do not provide any insight into what “an insignificant amount” means (larger than a peppercorn?). “Insignificant amount” may provide little tolerance for error. This encourages partnerships to meet the Treasury Regulations convention for agreements on fair market values of contributed assets.

If the agreed fair market value fails to meet the conditions for respecting the agreed fair market value and overstates or understates the correct value by more than an insignificant amount, the fair market value of a contributed asset should be determined under general federal income tax principles. This determination should apply this standard derived from the estate tax rules:

“The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a particular item of property includible in the decedent’s gross estate is not to be determined by a forced sale price. Nor is the fair market value of an item of property to be determined by the sale price of the item in a market other than that in which such item is most commonly sold to the public, taking into account the location of the item wherever appropriate. Thus, in the case of an item of property includible in the decedent’s gross estate, which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) includible in the decedent’s gross estate is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile of the decedent would be purchased by a dealer in used automobiles. . . . The value is generally to be determined by ascertaining as a basis the fair market value as of the applicable valuation date of each unit of property. For example, in the

\textsuperscript{936} Id.
case of shares of stock or bonds, such unit of property is generally a share of stock or a bond. Livestock, farm machinery, harvested and growing crops must generally be itemized and the value of each item separately returned. Property shall not be returned at the value at which it is assessed for local tax purposes unless that value represents the fair market value as of the applicable valuation date. All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. The value of items of property which were held by the decedent for sale in the course of a business generally should be reflected in the value of the business. . . .

This standard for fair market values generally prevails across the tax laws. The determination of fair market value often leads to litigation between taxpayers and the IRS. The willing buyer-willing seller standard (with little tolerance for error) would place a great burden on the partners to get the fair market value right when they agree on fair market value at the time of contribution. Failure to get the value right could deprive allocations of substantial economic effect and could lead to errors in applying Section 704(c)(1)(A).

No evidence is apparent that the IRS has a consistent policy of questioning fair market value allocations in partnership agreements in accordance with any organized audit strategy. This nevertheless may be an area of vulnerability for some partnerships where partners have been careless in their determinations of fair market values of contributed assets and where they do not meet all of the requirements of the convention for accepting agreed fair market values.

Post-contribution events sometimes adjust the agreed fair market value of an asset. For example, an adverse environmental condition sometimes is discovered after the contribution – or perhaps the partners recognize the condition at the time of contribution but the full extent of the cost becomes apparent only after the contribution. Some partnership agreements will provide for a post-contribution downward adjustment to the value of the contribution and to the contributing partner’s capital account. Some partnership agreements provide for the contributing partner to make post-contribution indemnity payments to the partnership. The tax treatment of these indemnity payments has not been definitively determined. Neither the Section 704(b) Treasury Regulations nor the Section 704(c)(1)(A) Treasury Regulations directly address post-contribution events or discoveries that may affect the value of contributed assets. The issues created by post-contribution adjustments to the values of contributed assets are outside the scope of this Article.

c. Property-by-Property Application.

Section 704(c)(1)(A) (with limited exceptions)\footnote{Exceptions permitting aggregation are discussed in Treas. Reg. § 1.704-3(e)(2). Aggregation is permitted for assets in the same general asset account class, for zero adjusted tax basis property, for inventory other than qualified financial assets, and securities of securities partnerships.} applies on a property-by-property basis.\footnote{Treas. Reg. § 1.704-3(a)(2).} Built-in gains and built-in losses on different items of contributed property generally cannot be aggregated.\footnote{\textit{Id.}} This principle is particularly important when setting up the partnership arrangement and dealing with capital contributions made in-kind. The partnership needs fair market value and basis information on an asset-by-asset basis. The partnership agreement does not clearly meet the Treasury Regulations’ requirements when it sets forth the aggregate fair market value of a partner’s capital contribution without specifying the fair market value of each contributed asset. An agreed aggregate fair market value agreement may not meet the requirements of the convention for accepting agreed fair market values. This aggregate fair market value should be clearly partitioned among all contributed assets by stating the fair market value of each contributed asset. For this purpose, land and improvements should be treated as separate assets. Where separately depreciable components have been properly identified, the fair market value of each separately depreciable component should be stated. The partnership agreement or a separate contribution agreement should set forth the separate fair market values of each separately depreciable improvement and the underlying land. The task can be significant when cost segregation is used. Aggregating land and improvements will produce trouble for the partnership accountants.

d. Limited to True Contributions.

Section 704(c)(1)(A) applies to a contribution of property by a partner to a partnership only if the transaction is treated as a true nonrecognition contribution transaction subject to the rules of Section 721. Section 704(c)(1)(A) does not apply to the extent that a transaction is treated as a disguised sale transaction under Section 707.

e. General Principles.

Treasury Regulations outline these general principles for applying the traditional method:

- In general, when the partnership has income, gain, loss, or deduction attributable to Section 704(c) property, the partnership must
make appropriate allocations to the partners to avoid shifting the tax consequences of the built-in gain or loss.

- If the partnership sells Section 704(c) property and recognizes gain or loss, built-in gain or loss on the Section 704(c) property is allocated to the contributing partner.

- If the partnership sells a portion of (or an interest in) Section 704(c) property, a proportionate part of the built-in gain or loss is allocated to the contributing partner.

- For Section 704(c) property subject to amortization, depletion, depreciation, or other cost recovery deductions, the allocation of deductions attributable to these items takes into account built-in gain or loss on the Section 704(c) property.

- Tax allocations to the noncontributing partners of cost recovery deductions with respect to Section 704(c) property generally must equal (to the extent possible) “book” allocations to those partners.

- The total tax income, gain, loss, or deduction allocated to the partners for a taxable year with respect to Section 704(c) property cannot exceed the total partnership tax income, gain, loss, or deduction with respect to that Section 704(c) property for the taxable year (the ceiling rule).

- If a partnership has no Section 704(c) property the allocations from which are limited by the ceiling rule, the traditional method is reasonable when used for all contributed Section 704(c) property.\(^\text{941}\)


We can start with allocating partnership tax deductions from cost recovery on Section 704(c) property when the partnership has overall net “book” loss.

Example 2. Catherine and Mary form the CatMar partnership. Catherine contributes land with a fair market value of $1 million and an adjusted tax basis of $400,000 and improvements with a fair market value of $2 million and an adjusted tax basis of $1,800,000. Catherine receives a 70% interest in the income and capital of the CatMar partnership. Mary contributes $1,285,714 in cash to the CatMar partnership. Catherine receives a 30% interest in the capital, income, and losses of the CatMar partnership. All “book” income, gain, depreciation, and loss are allocated in accordance with these percentages. The improvements for tax purposes have a remaining cost recovery life of 10 years and are depreciable in

\(^\text{941}\) Treas. Reg. § 1.704-3(b)(1).
accordance with the straight-line method. Immediately after the contributions, the CatMar partnership has this balance sheet:

<table>
<thead>
<tr>
<th></th>
<th>AB</th>
<th>FMV</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,285,714</td>
<td>$1,285,714</td>
<td>$0</td>
</tr>
<tr>
<td>Land</td>
<td>$400,000</td>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>$1,800,000</td>
<td>$2,000,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$3,485,714</td>
<td>$4,285,714</td>
<td>$800,000</td>
</tr>
<tr>
<td><strong>Liabilities and Capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Capital Catherine</td>
<td>$2,200,000</td>
<td>$3,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Capital Mary</td>
<td>$1,285,714</td>
<td>$1,285,714</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$3,485,714</td>
<td>$4,285,714</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

The CatMar partnership has these tax items in its first taxable year:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax deductions from cost recovery</td>
<td>$(180,000)</td>
</tr>
<tr>
<td>Ordinary income from operations</td>
<td>$4,400,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>$(5,000,000)</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>$(780,000)</td>
</tr>
</tbody>
</table>
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and
Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The CatMar partnership has these “book” items in its first taxable year:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Book” cost recovery</td>
<td>($200,000)</td>
</tr>
<tr>
<td>Ordinary income from operations</td>
<td>$4,400,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>($5,000,000)</td>
</tr>
<tr>
<td>Net “book” income</td>
<td>($800,000)</td>
</tr>
</tbody>
</table>

Section 704(c)(1)(A) can be applied in accordance with this methodology when CatMar has tax deductions from cost recovery and overall net “book” losses.

First, determine the net “book” loss of CatMar. From above, we can see that the CatMar partnership has $800,000 in net “book” loss.

Second, allocate the net “book” loss of CatMar in accordance with the partnership agreement of CatMar. CatMar allocates partnership net loss 70% to Catherine and 30% to Mary. This results in this allocation:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Loss Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catherine</td>
<td>70%</td>
<td>($560,000)</td>
</tr>
<tr>
<td>Mary</td>
<td>30%</td>
<td>($240,000)</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>($800,000)</td>
</tr>
</tbody>
</table>

Third, determine each partner’s share of net “book” loss. This allocation is shown in the chart above.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property in accordance with the allocation of “book” loss, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The partnership agreement of the CatMar partnership allocates net income and net losses. Cost recovery deductions are a component of computing net income and net losses. Net losses are allocated 70% to Catherine and 30% to Mary. Each component of net losses is allocated 70% to Catherine and 30% to Mary. CatMar has $200,000 in “book” cost recovery deductions that must be allocated each year. “Book” cost recovery deductions are allocated:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catherine</td>
<td>70%</td>
<td>$140,000</td>
</tr>
<tr>
<td>Mary</td>
<td>30%</td>
<td>$60,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$200,000</td>
</tr>
</tbody>
</table>
Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property. The contributed improvements have a contributed adjusted tax basis of $1,800,000 and a cost recovery life of 10 years. The CatMar partnership will have tax deductions from cost recovery of $180,000 per year.

Sixth, isolate the noncontributing partner (Mary), who did not contribute the Section 704(c) property. Mary is treated as the noncontributing partner with respect to the Section 704(c) property, even though Mary may have contributed other property in kind. Mary’s share of “book” cost recovery deductions is $60,000.

Seventh, allocate to the noncontributing partner (Mary) all of the tax deductions from cost recovery from the Section 704(c) property until Mary receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property. Mary’s share of “book” cost recovery deductions is $60,000. The CatMar partnership has $180,000 in tax deductions from cost recovery. Mary is allocated tax deductions from cost recovery from the Section 704(c) property equal to her share of tax deductions from cost recovery: $60,000.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Catherine). The CatMar partnership has $180,000 in total tax deductions from cost recovery. CatMar allocated $60,000 in tax deductions from cost recovery to Mary in step 7. This leaves $120,000 in tax deductions from cost recovery to allocate to Catherine.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax deductions from cost recovery</td>
<td>$180,000</td>
</tr>
<tr>
<td>Tax deductions from cost recovery allocated to Mary</td>
<td>$60,000</td>
</tr>
<tr>
<td>Tax deductions from cost recovery allocated to Catherine</td>
<td>$120,000</td>
</tr>
</tbody>
</table>

This completes the allocation of tax deductions from cost recovery between Catherine and Mary.

g. **Cost Recovery Deductions: Overall Net “Book” Income.**

The next example involves allocation of tax deductions from cost recovery when the CatMar partnership has an overall net “book” income for the year.

Example 3. Catherine and Mary form the CatMar partnership. Catherine contributes land with a fair market value of $1 million and an adjusted tax basis of $400,000. Catherine also contributes improvements to the land with a fair market value of $2 million and an adjusted tax basis of $1,800,000. Catherine receives a 70% interest in the income and capital of the CatMar partnership. Mary contributes $1,285,714 in cash to the CatMar partnership. Mary receives a 30% interest in the capital, income, and losses of the CatMar partnership. All “book” income, gain, depreciation, and loss are allocated in accordance with these percentages.
The improvements for tax purposes have a remaining cost recovery life of 10 years. The improvements are depreciable in accordance with the straight-line method. Immediately after the contributions, the CatMar partnership has this balance sheet:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

<table>
<thead>
<tr>
<th></th>
<th>AB</th>
<th>FMV</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$1,285,714</td>
<td>$1,285,714</td>
<td>$0</td>
</tr>
<tr>
<td>Land</td>
<td>$400,000</td>
<td>$1,000,000</td>
<td>$600,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>$1,800,000</td>
<td>$2,000,000</td>
<td>$200,000</td>
</tr>
<tr>
<td>Total</td>
<td>$3,485,714</td>
<td>$4,285,714</td>
<td>$800,000</td>
</tr>
<tr>
<td><strong>Liabilities and Capital</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Capital Catherine</td>
<td>$2,200,000</td>
<td>$3,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Capital Mary</td>
<td>$1,285,714</td>
<td>$1,285,714</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$3,485,714</td>
<td>$4,285,714</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

The CatMar partnership has these tax items in its first taxable year:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax deductions from cost recovery</td>
<td>($180,000)</td>
<td></td>
</tr>
<tr>
<td>Ordinary income from operations</td>
<td>$4,400,000</td>
<td></td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery deductions)</td>
<td>($1,600,000)</td>
<td></td>
</tr>
<tr>
<td>Net taxable income</td>
<td>$2,620,000</td>
<td></td>
</tr>
</tbody>
</table>

The CatMar partnership has these “book” items in its first taxable year:

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>“Book” cost recovery</td>
<td>($200,000)</td>
<td></td>
</tr>
<tr>
<td>Ordinary income from operations</td>
<td>$4,400,000</td>
<td></td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery deductions)</td>
<td>($1,600,000)</td>
<td></td>
</tr>
<tr>
<td>Net “book” income</td>
<td>$2,600,000</td>
<td></td>
</tr>
</tbody>
</table>

We can apply Section 704(c)(1)(A) in accordance with this methodology when CatMar has tax deductions from cost recovery and overall net “book” income.

First, determine the net “book” income of CatMar. For above, we can see that the CatMar partnership has $2,600,000 in net “book” income.

Second, allocate the net “book” income of CatMar in accordance with the partnership agreement of CatMar. CatMar allocates partnership net “book” income 70% to Catherine and 30% to Mary. This results in this allocation:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Income Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catherine</td>
<td>70%</td>
<td>$1,820,000</td>
</tr>
</tbody>
</table>

855
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mary</td>
<td>30%</td>
<td>$780,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$2,600,000</td>
</tr>
</tbody>
</table>

Third, determine each partner’s share of net “book” income. This allocation is shown in the chart above.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property. in accordance with the allocation of net “book” income, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The partnership agreement of the CatMar partnership allocates net income and net losses. Cost recovery deductions are a component of computing net income and net losses. Net income is allocated 70% to Catherine and 30% to Mary. Each component of net income is allocated 70% to Catherine and 30% to Mary. CatMar has $200,000 in “book” cost recovery deductions that must be allocated each year. They are allocated:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Catherine</td>
<td>70%</td>
<td>$140,000</td>
</tr>
<tr>
<td>Mary</td>
<td>30%</td>
<td>$60,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property. The contributed improvements have a contributed adjusted tax basis of $1,800,000 and a cost recovery life of 10 years. The CatMar partnership will have cost recovery deductions of $180,000 per year from the Section 704(c) property.

Sixth, isolate the noncontributing partner (Mary), who did not contribute the Section 704(c) property. Mary is treated as the noncontributing partner with respect to the Section 704(c) property, even though Mary may have contributed other property in kind. Mary’s share of “book” cost recovery deductions is $60,000.

Seventh, allocate to the noncontributing partner (Mary) all of the tax deductions from cost recovery from the Section 704(c) property until Mary receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property. Mary’s share of “book” cost recovery deductions is $60,000. The CatMar partnership has $180,000 in cost recovery deductions. Mary is allocated tax deductions from cost recovery from the Section 704(c) property equal to her share of tax deductions from cost recovery: $60,000.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Catherine). The
SOMETHING ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

CatMar partnership has $180,000 in total tax deductions from cost recovery. CatMar allocated $60,000 in cost recovery deductions to Mary in step 7. This leaves $120,000 in tax deductions from cost recovery to allocate to Catherine. CatMar allocated $120,000 in cost recovery deductions to Catherine.

| Total tax deductions from cost recovery | $180,000 |
| Tax deductions from cost recovery allocated to Mary | $60,000 |
| Tax deductions from cost recovery allocated to Catherine | $120,000 |

This completes the allocation of cost recovery deductions between Catherine and Mary.

h. Cost Recovery Deductions: Contributions of Multiple Properties.

Where one partner contributes a depreciable Section 704(c) property and the other partner contributes another Section 704(c) property, the Section 704(c)(1)(A) computations are undertaken on an asset-by-asset basis. In undertaking allocations on the first asset, the contributor of that asset is treated as the contributor, and the other partner (or partners) is treated as the noncontributor. Any “book”-tax disparity in the noncontributor’s assets does not affect the allocations with respect to assets contributed by the contributor. Section 704(c)(1)(A) is applied separately to each Section 704(c) property, so that we undertake a set of Section 704(c)(1)(A) computations for each contributed asset.

Example 4. Christina and Kati form the Woods Ventures partnership. Christina contributes land with a fair market value of $3 million and an adjusted tax basis of $500,000 and improvements with a fair market value of $2 million and an adjusted tax basis of $1,300,000. Christina receives a 50% interest in the income and capital of the Woods Ventures partnership. Kati contributes $5 million fair market value in land to the Woods Ventures partnership and receives a 50% interest in the capital, income, and losses of the Woods Ventures partnership. Kati has an adjusted tax basis of $200,000 in the land that she contributes. All “book” income, gain, cost recovery, and loss of Woods Ventures are allocated in accordance with these percentages. The improvements for tax purposes have a remaining cost recovery life of 10 years and are depreciable in accordance with the straight-line method. Immediately after the contributions, the Woods Ventures partnership has this balance sheet:

<table>
<thead>
<tr>
<th></th>
<th>AB</th>
<th>FM V</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Improvements</td>
<td>$1,300,000</td>
<td>$2,000,000</td>
<td>7,000,000</td>
</tr>
<tr>
<td>Land</td>
<td>$5,000,000</td>
<td>$3,000,000</td>
<td>2,000,000</td>
</tr>
</tbody>
</table>
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

<table>
<thead>
<tr>
<th>Land</th>
<th>$2,000,000</th>
<th>$5,000,000</th>
<th>$4,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$2,000,000</td>
<td>$10,000,000</td>
<td>$8,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
</tr>
<tr>
<td>Capital Christina</td>
</tr>
<tr>
<td>Capital Kati</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

The Woods Ventures partnership has these tax items in its first taxable year:

<table>
<thead>
<tr>
<th>Tax deductions from cost recovery (Christina’s asset)</th>
<th>($130,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income from operations</td>
<td>$900,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>($100,000)</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>$670,000</td>
</tr>
</tbody>
</table>

The Woods Ventures partnership has these “book” items in its first taxable year:

| “Book” cost recovery (Christina’s asset) | ($200,000) |
| Ordinary income from operations          | $900,000   |
| Ordinary deductions from operations (exclusive of cost recovery) | ($100,000) |
| Net “book” income                        | $600,000   |

Christina has contributed low basis Section 704(c) property. Kati has contributed moderately low basis Section 704(c) property. The basis in Kati’s contributed Section 704(c) property will not affect the allocation of cost recovery deductions. Section 704(c)(1)(A) can be applied in accordance with this methodology:

First, determine the net “book” income of Woods Ventures. Woods Ventures has net “book” income of $600,000.

Second, allocate the net “book” income of Woods Ventures in accordance with Woods Ventures partnership agreement. Woods Ventures is a 50/50 partnership. Each of Christina and Kati has a $300,000 share of net “book” income.
Third, determine each partner’s share of net “book” income. Each of Christina and Kati has a $300,000 share of net “book” income.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property in accordance with the allocation of net “book” income, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The “book” cost recovery deductions are a component of net “book” income of Woods Ventures. “Book” cost recovery deductions are allocated in the same percentages as allocations of “book” income. Woods Ventures has $200,000 of “book” cost recovery deductions available for allocation. “Book” deductions are allocated $100,000 to Christina and $100,000 to Kati. This is the same ratio in which net “book” income is allocated.

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property. Woods Ventures has $130,000 in tax deductions from cost recovery with respect to the Section 704(c) property available to allocate.

Sixth, isolate the noncontributing partner (Kati), who did not contribute the Section 704(c) property.

Seventh, allocate to the noncontributing partner (Kati) all of the tax deductions from cost recovery from the Section 704(c) property until Kati receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property. Kati’s share of “book” deductions is $100,000. The first $100,000 of tax deductions from cost recovery is allocated to Kati.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Christina). Woods Ventures has $130,000 in tax deductions from cost recovery with respect to the Section 704(c) property available to allocate. Woods Ventures allocated $100,000 to Kati. Woods Ventures has $30,000 that remains to allocate to Kati.

The land contributed by Kati is nondepreciable and is not sold, so there are no Section 704(c)(1)(A) computations with respect to the land. If the land were sold (or if it were improved property), we should undertake separate Section 704(c)(1)(A) computations with respect to the land.

The example set forth below illustrates the allocation of tax deductions from cost recovery where more than one partner contributes a Section 704(c) property. We should undertake separate Section 704(c)(1)(A) computations with respect to each contributed asset. The Section 704(c)(1)(A) computations with respect to one asset do not affect the Section 704(c)(1)(A) computations with respect to other Section 704(c) property. The same methodology would be used if a contributing partner contributed a number of Section 704(c) properties: we should undertake a separate Section 704(c)(1)(A) with respect to each Section 704(c) property. The computations can become challenging indeed when many deprecia-
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

Ble assets are contributed to a partnership. Accountants often adopt aggregating conventions not permitted by the Treasury Regulations. These conventions can expose partnerships to potential audit adjustments and possibly penalties.

Example 5. Christina and Kati form the Woods Ventures partnership. Christina contributes land with a fair market value of $3 million and an adjusted tax basis of $500,000 and improvements with a fair market value of $2 million and an adjusted tax basis of $1,300,000. Christina receives a 50% interest in the income and capital and losses of the Woods Ventures partnership. Kati contributes land with a fair market value of $2 million and adjusted tax basis of $500,000. Kati contributes a building with a fair market value of $3 million and adjusted tax basis of $100,000. Kati receives a 50% interest in the capital, income, and losses of the Woods Ventures partnership. All “book” income, gain, cost recovery, and loss of Woods Ventures is allocated in accordance with these percentages. The improvements for tax purposes have a remaining cost recovery life of 10 years and are depreciable in accordance with the straight-line method. Immediately after the contributions, the Woods Ventures partnership has this balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>AB</th>
<th>FMV</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improvements (Christina)</td>
<td>$1,300,000</td>
<td>$2,000,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Land (Christina)</td>
<td>$500,000</td>
<td>$3,000,000</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Improvements (Kati)</td>
<td>$100,000</td>
<td>$3,000,000</td>
<td>$2,900,000</td>
</tr>
<tr>
<td>Land (Kati)</td>
<td>$100,000</td>
<td>$2,000,000</td>
<td>$1,900,000</td>
</tr>
<tr>
<td>Total</td>
<td>$2,000,000</td>
<td>$10,000,000</td>
<td>$8,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities and Capital</th>
<th>AB</th>
<th>FMV</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Capital Christina</td>
<td>$600,000</td>
<td>$5,000,000</td>
<td>$4,400,000</td>
</tr>
<tr>
<td>Capital Kati</td>
<td>$200,000</td>
<td>$5,000,000</td>
<td>$4,800,000</td>
</tr>
<tr>
<td>Total</td>
<td>$800,000</td>
<td>$10,000,000</td>
<td>$9,200,000</td>
</tr>
</tbody>
</table>

The Woods Ventures partnership has these tax items in its first taxable year:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax deductions from cost recovery (Christina’s asset)</td>
<td>($130,000)</td>
</tr>
<tr>
<td>Tax deductions from cost recovery (Kati’s asset)</td>
<td>($10,000)</td>
</tr>
<tr>
<td>Ordinary income from operations</td>
<td>$900,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>($100,000)</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>$660,000</td>
</tr>
</tbody>
</table>

The Woods Ventures partnership has these “book” items in its first taxable year:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Book” cost recovery (Christina’s asset)</td>
<td>($200,000)</td>
</tr>
</tbody>
</table>
“Book” cost recovery (Kati’s asset) | ($300,000)
---|---
Ordinary income from operations | $900,000
Ordinary deductions from operations (exclusive of cost recovery) | ($100,000)
Net “book” income | $300,000

Christina has contributed low basis property. Kati has contributed moderately low basis property. The basis in Kati’s contributed property will not affect the allocation of tax cost recovery with respect to Christina’s property. The basis in Christina’s contributed property will not affect the allocation of tax cost recovery with respect to Kati’s property. Section 704(c)(1)(A) computations should be undertaken separately with respect to each of the properties.

We can start with the computations with respect to the Section 704(c) property contributed by Christina.

First, determine the net “book” income of Woods Ventures. Woods Ventures has net “book” income of $300,000.

Second, allocate the net “book” income of Woods Ventures in accordance with Woods Ventures partnership agreement. Woods Ventures is a 50/50 partnership. Each of Christina and Kati has a $150,000 share of net “book” income.

Third, determine each partner’s share of net “book” income. Each of Christina and Kati has a $150,000 share of net “book” income.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property contributed by Christina in accordance with the allocation of net “book” income, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The “book” cost recovery deductions are a component of net “book” income of Woods Ventures. “Book” cost recovery deductions are allocated in the same percentages as allocations of “book” income. Woods Ventures has $200,000 of “book” cost recovery deductions from the Section 704(c) property contributed by Christina available for allocation. “Book” deductions from the Section 704(c) property contributed by Christina are allocated $100,000 to Christina and $100,000 to Kati. This is the same ratio in which net “book” income is allocated. Note that if Christina contributed more than or Section 704(c) property that produced cost recovery deductions, it would be necessary to undertake separate computations with respect to each of these assets.

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property contributed by Christina. Woods Ventures has $130,000 in tax deductions from cost recovery with respect to the Section 704(c) property contributed by Christina available to allocate.
Sixth, isolate the noncontributing partner (Kati), who did not contribute the Section 704(c) property contributed by Christina.

Seventh, allocate to the noncontributing partner (Kati) all of the tax deductions from cost recovery from the Section 704(c) property contributed by Christina until Kati receives a share of tax deductions from cost recovery from the Section 704(c) property contributed by Christina equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property contributed by Christina. Kati’s share of “book” deductions from the Section 704(c) property contributed by Christina is $100,000. The first $100,000 of tax deductions from cost recovery from the Section 704(c) property contributed by Christina are allocated to Kati.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Christina). Woods Ventures has $130,000 in tax deductions from cost recovery with respect to the Section 704(c) property contributed by Christina available to allocate. The first $100,000 of these deductions was allocated to Kati in step seven. Woods Ventures has $30,000 of tax deductions from cost recovery with respect to this property available to allocate to Kati. All of the remaining $30,000 in tax deductions from this property is allocated to Kati.

Next, we should undertake the Section 704(c)(1)(A) computations with respect to cost recovery with respect to the Section 704(c) property contributed by Kati. Fortunately, we can borrow on some of the work that we have done above.

First, determine the net “book” income of Woods Ventures. Woods Ventures has net “book” income of $300,000.

Second, allocate the net “book” income of Woods Ventures in accordance with Woods Ventures partnership agreement. Each of Kati and Christina has a $150,000 share of net “book” income.

Third, determine each partner’s share of net “book” income. Each of Kati and Christina has a $150,000 share of net “book” income.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property contributed by Kati in accordance with the allocation of net “book” income, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The “book” cost recovery deductions are a component of net “book” income of Woods Ventures. “Book” cost recovery deductions are allocated in the same percentages as allocations of “book” income. Woods Ventures has $300,000 of “book” cost recovery deductions from the Section 704(c) property contributed by Kati available for allocation. “Book” deductions from the Section 704(c) property contributed by Kati are allocated $150,000 to Kati and $150,000 to Christina. This is the same ratio in which net “book” income is allocated. Note that if Kati contributed more than or
Section 704(c) property that produced cost recovery deductions, it would be necessary to undertake separate computations with respect to each of these assets.

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property contributed by Kati. Woods Ventures has $10,000 in tax deductions from cost recovery with respect to the Section 704(c) property contributed by Kati available to allocate.

Sixth, isolate the noncontributing partner (Christina), who did not contribute the Section 704(c) property contributed by Kati.

Seventh, allocate to the noncontributing partner (Christina) all of the tax deductions from cost recovery from the Section 704(c) property contributed by Kati until Christina receives a share of tax deductions from cost recovery from the Section 704(c) property contributed by Kati equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property contributed by Kati. Christina’s share of “book” deductions from the Section 704(c) property contributed by Kati is $150,000. The first $150,000 of tax deductions from cost recovery from the Section 704(c) property contributed by Kati is allocated to Christina. Only $10,000 in tax deductions is available for allocation to Christina. Christina is allocated $10,000 in tax deductions from cost recovery with respect to the Section 704(c) property contributed by Kati, but that is all. Nothing is done under the traditional method to correct this deficiency.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Kati). No tax deductions from cost recovery with respect to the Section 704(c) property contributed by Kati are available to allocate to Kati. Kati receives no tax deductions from cost recovery with respect to the Section 704(c) property that she contributed.

i. Cost Recovery Deductions: Ceiling Rule.

The next example is based on Example 1 from Treasury Regulations on the traditional method: 942

Example 6. Al and Barbara form BarbAl Partners. Al and Barbara agree that each will be allocated a 50 percent share of all partnership items. All “book” income, gain, depreciation, and loss is allocated in accordance with these percentages. BarbAl Partners will make allocations under Section 704(c)(1)(A) using the traditional method. Al contributes depreciable property with an adjusted tax basis of $4,000 and a “book” value of $10,000. Barbara contributes $10,000 cash. Al has built-in gain of $6,000: the excess of (i) BarbAl Partners’ “book” value for the Section 704(c) property contributed by Al ($10,000) over (ii) Al’s adjusted

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tax basis in the Section 704(c) property contributed by Al at the time of contribution ($4,000). The Section 704(c) property is depreciated using the straight-line method over a 10-year cost recovery deductions period.

In BarbAl Partners’ first year, the proceeds generated by the equipment exactly equal BarbAl Partners’ operating expenses.

Section 704(c)(1)(A) can be applied in accordance with this methodology when BarbAl Partners has tax deductions from cost recovery and overall net “book” loss.

- First, determine the net “book” loss of BarbAl Partners.
- Second, allocate the net “book” loss of BarbAl Partners in accordance with the partnership agreement of BarbAl Partners.
- Third, determine each partner’s share of net “book” loss.
- Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property in accordance with the allocation of net “book” loss, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. “Book” cost recovery deductions are a component of net “book” loss and are allocated in the same percentages.
- Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property.
- Sixth, isolate the noncontributing partner (Barbara), who did not contribute the Section 704(c) property.
- Seventh, allocate to the noncontributing partner (Barbara) all of the tax deductions from cost recovery from the Section 704(c) property until Barbara receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions from the Section 704(c) property.
- Eighth, allocate all remaining tax deductions from cost recovery from the Section 704(c) property to the contributing partner (Al).

The discussion in the analysis in the Treasury Regulations skips the first two steps and directly determines each partner’s share of “book” cost recovery deductions with respect to the depreciable property contributed by Al.

Third, determine each partner’s share of net “book” loss. The Section 704(c) property contributed by Al depreciates at an annual rate of 10 percent. BarbAl Partners will have $1,000 in “book” cost recovery deductions from the Section 704(c) property and $400 in tax deductions from cost recovery every year
from the Section 704(c) property. This shows the partners’ respective shares of “book” cost recovery deductions from the Section 704(c) property:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Al</td>
<td>50%</td>
<td>$500</td>
</tr>
<tr>
<td>Barbara</td>
<td>50%</td>
<td>$500</td>
</tr>
</tbody>
</table>

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property in accordance with the allocation of “book” loss, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. Each partner is allocated $500 of “book” cost recovery deductions per year from the Section 704(c) property. See chart in step 3.

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property. BarbAl has $400 in cost recovery deductions for tax purposes available from the Section 704(c) property. BarbAl Partners is allowed tax deductions from cost recovery of only $400 per year (10 percent of $4,000) from the Section 704(c) property.

Sixth, isolate the noncontributing partner (Barbara), who did not contribute the Section 704(c) property.

Seventh, allocate to the noncontributing partner (Barbara) all of the tax deductions from cost recovery from the Section 704(c) property until Barbara receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions from the Section 704(c) property. Barbara would have been entitled to cost recovery deductions of $500 per year from the Section 704(c) property for both “book” and tax purposes if the adjusted tax basis of the Section 704(c) property contributed by Al equaled its fair market value at the time of contribution. BarbAl Partners can allocate only $400 of tax deductions from cost recovery from the Section 704(c) property under the ceiling rule. BarbAl Partners has only $400 of tax deductions from cost recovery from the Section 704(c) property to allocate. All of the tax deductions from cost recovery from the Section 704(c) property must be allocated to Barbara. Not enough tax deductions from cost recovery from the Section 704(c) property are available to allocate to Barbara a share of tax deductions from cost recovery from the Section 704(c) property equal to Barbara’s share of the “book” cost recovery deductions from the Section 704(c) property. The traditional method does not have any mechanism for correcting this deficiency.

Eighth, allocate all remaining tax deductions from cost recovery from the Section 704(c) property to the contributing partner (Al). No remaining tax deductions from cost recovery from the Section 704(c) property are available to allocate to Al.
At the end of the first year, the “book” value of the Section 704(c) property is $9,000: $10,000 less the $1,000 “book” cost recovery deductions deduction.

The adjusted tax basis of the Section 704(c) property is $3,600: $4,000 less the $400 tax deductions from cost recovery deduction.

Al’s built-in gain with respect to the Section 704(c) property decreases to $5,400: $9,000 “book” value less $3,600 adjusted tax basis.

At the end of BarbAl Partners’ first year,
• Al has a $9,500 “book” capital account.
• Al has a $4,000 adjusted tax basis in Al’s partnership interest.
• Barbara has a $9,500 “book” capital account.
• Barbara has a $9,600 adjusted tax basis in Barbara’s partnership interest.

j. Gain on Sale: Tax Gain but no “Book” Gain.

The next example illustrates computing gain on sale after an asset has depreciated.943

Example 7. In Example 6, BarbAl Partners sells the Section 704(c) property at the beginning of BarbAl Partners’ second year for $9,000. BarbAl Partners realizes tax gain of $5,400: $9,000 amount realized, less the adjusted tax basis of $3,600.

We can apply Section 704(c)(1)(A) in this case in accordance with this methodology:

First, determine the net “book” gain of BarbAl Partners from the sale. The amount realized is $9,000. The “book” value of the Section 704(c) property at the end of the first year is $9,000: $10,000 less the $1,000 “book” cost recovery deductions deduction. No “book” gain or loss is available to allocate.

Second, allocate the net “book” gain of BarbAl Partners in accordance with the partnership agreement of BarbAl Partners. No “book” gain is available to allocate.

Third, determine each partner’s share of net “book” gain. No “book” gain is available to allocate. No partner will have a share of book gain.

---

943 This example is taken from Treas. Reg. § 1.704-3(b)(2), Example 1.
Fourth, determine tax gains with respect to the Section 704(c) property. BarbAl Partners realizes tax gain of $5,400: $9,000 amount realized, less the adjusted tax basis of $3,600.

Fifth, isolate the noncontributing partner (Barbara), who did not contribute the Section 704(c) property.

Sixth, allocate to the noncontributing partner (Barbara) all of the tax gains until Barbara receives a share of tax gain from the Section 704(c) property equal to her share of “book” gain from the Section 704(c) property. BarbAl Partners has $5,400 in tax gain available to allocate. No “book” gain is available to allocate. Barbara has no share of “book” gain from the Section 704(c) property. Barbara receives no allocation of tax gain from the Section 704(c) property.

Seventh, allocate all remaining tax gains to the contributing partner (Al). BarbAl has $5,400 in tax gain available to allocate. All of the tax gain is allocated to Al. The entire $5,400 gain must be allocated to Al because the Section 704(c) property Al contributed has that much built-in gain remaining.

$5,400 of tax gain must be allocated to Al to account for Al’s built-in gain. The remaining $1,000 of tax gain is allocated equally between Al and Barbara in accordance with the partnership agreement of BarbAl Partners.

k. Gain on Sale: Tax Gain and “Book” Gain.

The next example shows the effect of the sale of Section 704(c) property with “book” income and taxable income.

Example 8. In Example 7, BarbAl Partners sells the Section 704(c) property at the beginning of BarbAl Partners’ second year for $10,000 (rather than $9,000). BarbAl Partners realizes tax gain of $6,400: $10,000 (the amount realized) less the adjusted tax basis of $3,600.

Section 704(c)(1)(A) can be applied in accordance with this methodology in this case:

First, determine the net “book” gain of BarbAl Partners from the sale. The amount realized is $10,000. The “book” value of the Section 704(c) property at the end of the first year is $9,000: $10,000 less the $1,000 “book” cost recovery deductions deduction. The “book” gain is $1,000: $10,000 minus $9,000.

Second, allocate the net “book” gain of BarbAl Partners in accordance with the partnership agreement of BarbAl Partners. BarbAl has $1,000 of “book” gain available to allocate. The BarbAl Partners agreement allocates “book” gain 50 percent to each partner. Each partner has a $500 share of “book” gain.

Third, determine each partner’s share of net “book” gain. This shows the partners’ respective shares of net “book” gain:
**Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements**

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barbara</td>
<td>50%</td>
<td>$500</td>
</tr>
<tr>
<td>Al</td>
<td>50%</td>
<td>$500</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

*Fourth, determine tax gains with respect to the Section 704(c) property. BarbAl Partners realizes tax gain of $6,400. This is $10,000 (the amount realized) less the adjusted tax basis of $3,600.*

*Fifth, isolate the noncontributing partner (Barbara), who did not contribute the Section 704(c) property.*

*Sixth, allocate to the noncontributing partner (Barbara) all of the tax gains until Barbara receives a share of tax gain from the Section 704(c) property equal to her share of “book” gain from the Section 704(c) property. BarbAl has $6,400 in tax gain available to allocate. BarbAl has $1,000 of “book” gain available to allocate. Barbara’s share of “book” gain is $500. Barbara receives a $500 allocation of tax gain from the Section 704(c) property.*

*Seventh, allocate all remaining tax gains to the contributing partner (Al). BarbAl has $6,400 in tax gain available to allocate. We have already allocated $500 of the tax gain to Barbara. The entire remaining $5,900 gain must be allocated to Al because the Section 704(c) property Al contributed has that much built-in gain remaining.*

This chart shows the results of the sale of the Section 704(c) property at various sale prices. It assumes that the “book” basis of the Section 704(c) property is $9,000 and that the adjusted tax basis of the Section 704(c) property is $3,600. “Book” gain from the sale of the Section 704(c) property is allocated 50% to Al and 50% to Barbara under the partnership agreement. Tax allocations of gain from sale of the Section 704(c) property follow the principles of Section 704(c)(1)(A).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

<table>
<thead>
<tr>
<th>Amount Realized</th>
<th>Partnership “Book” Gain (Loss)</th>
<th>Partnership Tax Gain (Loss)</th>
<th>Al’s “Book” Gain (Loss)</th>
<th>Barbara’s “Book” Gain (Loss)</th>
<th>Al’s Tax Gain (Loss)</th>
<th>Barbara’s Tax Gain (Loss)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>($8,000)</td>
<td>($2,600)</td>
<td>($4,000)</td>
<td>($4,000)</td>
<td>($5,400)</td>
<td>($2,600)</td>
</tr>
<tr>
<td>$2,000</td>
<td>($7,000)</td>
<td>($1,600)</td>
<td>($3,500)</td>
<td>($3,500)</td>
<td>($5,400)</td>
<td>($1,600)</td>
</tr>
<tr>
<td>$3,000</td>
<td>($6,000)</td>
<td>($600)</td>
<td>($3,000)</td>
<td>($3,000)</td>
<td>($5,400)</td>
<td>($600)</td>
</tr>
<tr>
<td>$4,000</td>
<td>($5,000)</td>
<td>$400</td>
<td>($2,500)</td>
<td>($2,500)</td>
<td>($5,000)</td>
<td>$0</td>
</tr>
<tr>
<td>$5,000</td>
<td>($4,000)</td>
<td>$1,400</td>
<td>($2,000)</td>
<td>($2,000)</td>
<td>($4,000)</td>
<td>$0</td>
</tr>
<tr>
<td>$6,000</td>
<td>($3,000)</td>
<td>$2,400</td>
<td>($1,500)</td>
<td>($1,500)</td>
<td>($3,000)</td>
<td>$0</td>
</tr>
<tr>
<td>$7,000</td>
<td>($2,000)</td>
<td>$3,400</td>
<td>($1,000)</td>
<td>($1,000)</td>
<td>($2,000)</td>
<td>$0</td>
</tr>
<tr>
<td>$8,000</td>
<td>($1,000)</td>
<td>$4,400</td>
<td>($500)</td>
<td>($500)</td>
<td>($1,000)</td>
<td>$0</td>
</tr>
<tr>
<td>$9,000</td>
<td>$0</td>
<td>$5,400</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>$10,000</td>
<td>$1,000</td>
<td>$6,400</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
<td>$500</td>
</tr>
<tr>
<td>$11,000</td>
<td>$2,000</td>
<td>$7,400</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>$12,000</td>
<td>$3,000</td>
<td>$8,400</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
<td>$1,500</td>
</tr>
<tr>
<td>$13,000</td>
<td>$4,000</td>
<td>$9,400</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>$14,000</td>
<td>$5,000</td>
<td>$10,400</td>
<td>$2,500</td>
<td>$2,500</td>
<td>$2,500</td>
<td>$2,500</td>
</tr>
<tr>
<td>$15,000</td>
<td>$6,000</td>
<td>$11,400</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

These computations illustrate the same principles as illustrated in prior examples.

- First, compute “book” gain or “book” loss from sale with respect to the Section 704(c) property that is sold.
- Second, allocate this “book” gain or “book” loss in accordance with the partnership agreement. This gain or loss may be allocated as a competent of Net Profits or Net Losses. If so, you must see how the “book” items with respect to the Section 704(c) property are allocated on a disaggregated basis. Where “book” gain or “book” loss from the sale of Section 704(c) property is aggregated with other items, the “book” gain or “book” loss from the sale of the Section 704(c) property should be allocated among the partners in the same percentages as the aggregate amount is allocated.
- Third, determine each partner’s share of the “book” gain or “book” loss with respect to the Section 704(c) property that is sold.
- Fourth, identify the noncontributing partner (or partners).
- Fifth, determine tax gain or tax loss from sale with respect to the Section 704(c) property that is sold.
Sixth, allocate tax gain or tax loss (as the case may be) from the sale of the particular Section 704(c) property to the noncontributing partner (or partners) so as to put her in the same situation (to the extent possible) that she would be in if “book” gain and tax gain (or “book” loss and tax loss) from the sale of the particular Section 704(c) property were the same. Give the noncontributing partner an allocation of tax items from the sale of the particular Section 704(c) property to put the noncontributing partner in the same situation she should be in as indicated by the “book” allocation from the sale of the particular Section 704(c) property. If the sale of the particular Section 704(c) property produces “book” gain, allocate tax income from the sale of the particular Section 704(c) property to the noncontributing partner to the extent of her share of “book” gain (or, if less, give her all of the tax gain) from the sale of the particular Section 704(c) property. If the sale produces “book” gain and tax loss, do not give the noncontributing partner any allocation of any tax items from the sale of the particular Section 704(c) property. If the sale produces “book” loss and tax loss, allocate tax loss from the sale of the particular Section 704(c) property to the noncontributing partner to the extent of her share of “book” loss (or, if less, give her all of the tax loss) from the sale of the particular Section 704(c) property. If the sale produces “book” loss and tax gain, do not give the noncontributing partner any allocation of tax items from the sale of the particular Section 704(c) property. If you hit the ceiling rule (you do not have enough tax items from the sale of the particular Section 704(c) property to put the noncontributing partner in her “book” position from the sale of the particular Section 704(c) property (or the tax items from the sale of the particular Section 704(c) property are of the wrong character)), then go to step seven.

Seventh, allocate all remaining tax items from the sale of the particular Section 704(c) property to the contributing partner.

This methodology can be used even where the partnership does not explicitly allocate “book” items or where the “book” items are allocated through a target capital account allocation. The key is first to determine how “book” items are allocated regardless of the partnership’s methodology of allocating “book” items. The remainder of the steps are mechanical after one determines the partnership’s allocation of “book” items. We sometimes must infer allocations of “book” items from the overall economics of the partnership.
I. Partnerships Not Using Capital Accounts.

Partnerships that do not maintain capital accounts under Section 704 principles do not acquire immunity from Section 704(c)(1)(A). Partnerships are required to comply with the rules of Section 704(c)(1)(A) regardless of whether the partnerships maintain capital accounts in accordance with the principles of Section 704. This requires computing and allocating “book” items as if the partnerships complied with Section 704 rules. Partnerships that do not account for tax items under the capital accounting rules of Treasury Regulations on substantial economic effect may adopt any of a wide variety of conventions. These partnerships nevertheless are fully subject to the rules of Section 704(c)(1)(A) as if they maintained capital accounts in accordance with Treasury Regulations on substantial economic effect.\textsuperscript{944} Even partnerships that do not maintain capital accounts should be able to take advantage of the convention for accepting agreed fair market values if they meet its requirements.\textsuperscript{945}

Example 9. Laura and Gabrielle form the Laurielle partnership. Laura contributes land with a fair market value of $1 million and an adjusted tax basis of $600,000 and improvements with a fair market value of $2 million and an adjusted tax basis of $1,600,000. Laura receives a 50% interest in the income and capital of the Laurielle partnership. Gabrielle contributes $3,000,000 in cash to the Laurielle partnership. Gabrielle receives a 50% interest in the capital, income, and losses of the Laurielle partnership. All “book” income, gain, depreciation, and loss are allocated in accordance with these percentages. The improvements for tax purposes have a remaining cost recovery life of 10 years and are depreciable in accordance with the straight-line method. Immediately after the contributions, the Laurielle partnership has this balance sheet:

<table>
<thead>
<tr>
<th></th>
<th>AB</th>
<th>FMV</th>
<th>Δ</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>$3,000,000</td>
<td>$3,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Land</td>
<td>$600,000</td>
<td>$1,000,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Improvements</td>
<td>$1,600,000</td>
<td>$2,000,000</td>
<td>$400,000</td>
</tr>
<tr>
<td>Total</td>
<td>$5,200,000</td>
<td>$6,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Liabilities and Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Liabilities</td>
<td></td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Capital Laura</td>
<td>$2,200,000</td>
<td>$3,000,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>Capital Gabrielle</td>
<td>$3,000,000</td>
<td>$3,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Total</td>
<td>$5,200,000</td>
<td>$6,000,000</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

\textsuperscript{944} Treas. Reg. § 1.704-1(b)(2)(iv).

\textsuperscript{945} See discussion in text beginning at 926.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The Laurielle partnership has these tax items in its first taxable year:

<table>
<thead>
<tr>
<th>Tax deductions from cost recovery</th>
<th>($160,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income from operations</td>
<td>$5,175,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>($5,000,000)</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>$15,000</td>
</tr>
</tbody>
</table>

The Laurielle partnership has these “book” items in its first taxable year:

<table>
<thead>
<tr>
<th>“Book” cost recovery</th>
<th>($200,000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary income from operations</td>
<td>$5,175,000</td>
</tr>
<tr>
<td>Ordinary deductions from operations (exclusive of cost recovery)</td>
<td>($5,000,000)</td>
</tr>
<tr>
<td>Net taxable income</td>
<td>($25,000)</td>
</tr>
</tbody>
</table>

Section 704(c)(1)(A) can be applied in accordance with this methodology when Laurielle has tax deductions from cost recovery and overall net “book” losses. The methodology that we have used previously should apply even though Laurielle does not maintain capital accounts and its allocations do not meet the requirements of substantial economic effect.

First, determine the net “book” loss of Laurielle. From above, we can see that the Laurielle partnership has $25,000 in net “book” loss.

Second, allocate the net “book” loss of Laurielle in accordance with the partnership agreement of Laurielle. Laurielle allocates partnership net book loss 50% to Laura and 50% to Gabrielle. This results in this allocation:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Loss Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Laura</td>
<td>50%</td>
<td>($12,500)</td>
</tr>
<tr>
<td>Gabrielle</td>
<td>50%</td>
<td>($12,500)</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>($25,000)</td>
</tr>
</tbody>
</table>

Third, determine each partner’s share of net “book” loss. This allocation is shown in the chart above.

Fourth, allocate “book” cost recovery deductions with respect to the Section 704(c) property in accordance with the allocation of “book” loss, and determine each partner’s share of “book” cost recovery deductions with respect to the Section 704(c) property. The partnership agreement of the Laurielle partnership allocates net income and net losses. Cost recovery deductions are a component of computing net income and net losses. Net losses are allocated 50% to Laura and 50% to Gabrielle. Each component of net losses is allocated 50% to Laura and
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

50% to Gabrielle. Laurielle has $200,000 in “book” cost recovery deductions to allocate each year. “Book” cost recovery deductions are allocated:

<table>
<thead>
<tr>
<th>Partner</th>
<th>Percentage</th>
<th>“Book” Tax Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Laura</td>
<td>50%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Gabrielle</td>
<td>50%</td>
<td>$100,000</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>$200,000</td>
</tr>
</tbody>
</table>

Fifth, determine tax deductions from cost recovery with respect to the Section 704(c) property. The contributed improvements have a contributed adjusted tax basis of $1,600,000 and a cost recovery life of 10 years. The Laurielle partnership will have tax deductions from cost recovery of $160,000 per year.

Sixth, isolate the noncontributing partner (Gabrielle), who did not contribute the Section 704(c) property. Gabrielle is treated as the noncontributing partner with respect to the Section 704(c) property, even though Gabrielle may have contributed other property in kind. Gabrielle’s share of “book” cost recovery deductions is $100,000.

Seventh, allocate to the noncontributing partner (Gabrielle) all of the tax deductions from cost recovery from the Section 704(c) property until Gabrielle receives a share of tax deductions from cost recovery from the Section 704(c) property equal to her share of “book” cost recovery deductions with respect to the Section 704(c) property. Gabrielle’s share of “book” cost recovery deductions is $100,000. The Laurielle partnership has $160,000 in tax deductions from cost recovery. Gabrielle is allocated tax deductions from cost recovery from the Section 704(c) property equal to her share of tax deductions from cost recovery: $100,000.

Eighth, allocate all remaining tax deductions from cost recovery with respect to the Section 704(c) property to the contributing partner (Laura). The Laurielle partnership has $160,000 in total tax deductions from cost recovery. Laurielle allocated $100,000 in tax deductions from cost recovery to Gabrielle in step 7. This leaves $60,000 in tax deductions from cost recovery to allocate to Laura.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total tax deductions from cost recovery</td>
<td>$160,000</td>
</tr>
<tr>
<td>Tax deductions from cost recovery allocated to Gabrielle</td>
<td>$100,000</td>
</tr>
<tr>
<td>Tax deductions from cost recovery allocated to Laura</td>
<td>$60,000</td>
</tr>
</tbody>
</table>

This completes the allocation of tax deductions from cost recovery between Laura and Gabrielle. The methodology is unaffected by the failure of the partnership to maintain capital accounts in accordance with the Treasury Regulations.
m. Unreasonable Use of Traditional Method.

Section 704(c)(1)(A) is designed to prevent partners from shifting tax consequences with respect to precontribution gain or loss.\footnote{946} The allocation method that the partnership uses to allocate income, gain, loss, and deduction under Section 704(c)(1)(A) must be a reasonable method that is consistent with the purpose of Section 704(c)(1)(A). An anti-abuse rule provides: “An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.”\footnote{947} Very little thought seems to have been given to the theory and application of the anti-abuse rule. Two natural targets of the anti-abuse rule are situations where highly appreciated short-life depreciable property is contributed to a partnership and a noncontributing partner is a foreigner or a tax-exempt entity.

This anti-abuse rule is similar to the rules of “substantiality” under the Section 704(b) Treasury Regulations. It is not clear that the anti-abuse rule establishes the boundaries of when an allocation method is unreasonable and may not be used for Section 704(c)(1)(A) computations. The IRS arguably can apply the anti-abuse rule to the traditional method whenever the use of the traditional method results in cost recovery deductions being limited under the ceiling rule and the requisite “view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability” exists. This could be translated by an auditing agent [albeit with violence to the language of the anti-abuse rule] into the proposition that the IRS can apply the anti-abuse rule to avoid the traditional method whenever the IRS does not approve of the taxpayer using the ceiling-rule limited traditional method. If so, the anti-abuse rule could be substantially more powerful than is generally perceived.

The anti-abuse rule is dependent on evil view: view to shift tax consequences of the built-in gain or loss so as substantially as to reduce the present value of the partners’ aggregate tax liability. This view should require that someone have substantial knowledge of the tax attributes of the various partners, both currently and for the future. The anti-abuse rule should not be applied in the absence of the requisite view, regardless of the actual consequences. The evil view might well be enough for the anti-abuse rule to apply if the evil view were present and the ceiling rule applied, even if it ultimately were determined that the shifting of

\footnote{946} Treas. Reg. § 1.704-3(a)(1).
\footnote{947} Treas. Reg. § 1.704-3(a)(10).
present value of partners’ aggregate tax liability did not occur. Perhaps a partnership could avoid the application of the anti-abuse rule if the partnership scrupulously avoided partners sharing their personal tax information, so that no partner had knowledge that the shifting of present value of aggregate tax liability actually occurred. One could object, however, that the view may not require an actual shifting in fact, but merely that “the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.”

The partners’ view concerning shifting may turn out to be based on faulty knowledge or supposition. For example, the partners may imagine that a noncontributing partner has a substantial net operating loss, but that net operating loss may be eliminated upon audit of the noncontributing partner. The evil view nevertheless may still exist. The anti-abuse rule may apply.

The shifting must “substantially reduce[] the present value of the partners’ aggregate tax liability.” The Treasury Regulations provide us with little guidance concerning what “substantially” means in this context. The Treasury Regulations do not illuminate how the present value of the partners’ aggregate tax liability should be computed. The Treasury Regulations also do not give the partnership the resources necessary to find the information required to determine “the present value of the partners’ aggregate tax liability.”

The anti-abuse rule has two tests. The anti-abuse rule says that: “An allocation method (or combination of methods) is not reasonable if the contribution of property (or event that results in reverse section 704(c) allocations) and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.”

The corresponding allocation of tax items must be made with the evil view. Also, the contribution must be made with the evil view. There may be situations in which the allocation of tax items was made with the evil view, but the partnership can defend against the application of the anti-abuse rule because the evil view did not exist when the contribution was made. This might occur, for example, when the partnership is organized, contributions are made, and partners later discover that one partner is in a lower tax bracket than another. The partner-

---

948 Treas. Reg. § 1.704-3(a)(10).
949 Id.
950 Id.
951 Id.
ship then elects the traditional method “with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.”

Treasury Regulations do not provide a particularly good test for determining when a method is reasonable or unreasonable. The anti-abuse rule may provide only a set of circumstances under which a method cannot be used as unreasonable. Treasury Regulations detail three methods that are generally reasonable. These methods are the traditional method, the traditional method with curative allocations, and the remedial allocation method. Most partnerships apply one of these methods. Partnerships nevertheless are not necessarily constrained to use one of these methods. The principal constraint is that whatever method the partnership uses must be “reasonable” – without a terribly clear definition of what “reasonable” means.

The use of these methods also may be avoided by the IRS if they are unreasonable under the circumstances.

Treasury Regulations clarify that an allocation method is not necessarily unreasonable merely because another allocation method would result in a higher aggregate tax liability. (It is possible, however, that tax liability reduction and application of the ceiling rule is enough for the IRS to avoid the use of the traditional method under the anti-abuse rule.) Other methods may be reasonable in appropriate circumstances. Treasury Regulations provide anemic guidance concerning when methods not described in Treasury Regulations are reasonable or unreasonable. Treasury Regulations do clarify that (in the absence of specific published guidance) it is not reasonable to use an allocation method in which the adjusted tax basis of contributed property is increased (or decreased) to reflect built-in gain (or loss), or a method under which the partnership creates tax allocations of income, gain, loss, or deduction independent of allocations affecting book capital accounts.

Example 10. Charles and Doreen form CharDor Partners. Each will be allocated a 50 percent share of all partnership items. CharDor Partners will make allocations using the traditional method under Section 704(c). Charles contributes to CharDor Partners equipment with an adjusted tax basis of $1,000 and a “book” value of $10,000. Charles makes his contribution to CharDor Partners with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery deductions schedule (although its remaining economic life is significantly longer). Charles has a built-in gain of $9,000 at the time of contribu-

952 Id.
953 Id.
954 Id.
955 Id.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tion. The equipment is Section 704(c) property. Doreen contributes $10,000 of cash to CharDor Partners as her capital contribution. CharDor Partners uses the cash to buy securities. Doreen has substantial net operating loss carry forwards that Doreen anticipates will otherwise expire unused. CharDor Partners sells the equipment during the second year for $10,000 and recognizes a $10,000 gain: $10,000, the amount realized, less the adjusted tax basis of $0. Both the “book” value and adjusted tax basis of the equipment are $0 at the beginning of the second year.956

CharDor Partners must allocate the $10,000 of “book” depreciation to the partners in the first year.957 “Book” depreciation is allocated $5,000 to Charles and $5,000 to Doreen. Doreen is the noncontributing partner. CharDor has $10,000 of “book” depreciation available to allocate in the partnership’s first year. CharDor has $1,000 of tax depreciation available to allocate in the partnership’s first year. The $1,000 of tax depreciation must be allocated to Doreen to the extent of her $5,000 share of “book” depreciation. All of the $1,000 of tax depreciation in the first year is allocated to Doreen. Doreen’s depreciation deductions are substantially limited by the ceiling rule. No depreciation is available to allocate to Charles.

Both the “book” value and adjusted tax basis of the equipment are $0 after the first year. There is no remaining built-in gain at the beginning of the second year. There is no more built-in gain in the property after the first year. The property no longer is considered Section 704(c) property after the first year, since the “book”-tax disparity has been eliminated through “book” and tax depreciation. The $10,000 gain on the sale of the equipment in the second year is allocated $5,000 each to Charles and Doreen in accordance with the 50/50 allocation in the partnership agreement.

The analysis in the Treasury Regulations concludes that the interaction of the partnership’s one-year write-off of the entire “book” value of the equipment and the use of the traditional method results in a shift of $4,000 of the precontribution gain in the equipment from Charles to Doreen: Doreen’s $5,000 share of CharDor Partners’ $10,000 gain, less the $1,000 tax depreciation deduction previously allocated to Doreen. This shows the effects of the ceiling rule. Some advisors may wince and reflect that a $4,000 shift in precontribution gain does not seem like very much.

956 This example is an adaptation of Example 2 in Treas. Reg. § 1.704-3(b)(2).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The example in the Treasury Regulations concludes that the traditional method is not reasonable under the circumstances of this example. The contribution of property is made (and the traditional method is used), according to the example, with a view to shifting a significant amount of taxable income to a partner with a low marginal tax rate and away from a partner with a high marginal tax rate. It is not clear how this view was evidenced. The example assumes that this view to shift taxable income from the high bracket partner to the low bracket partner exists. The example fails to identify who has this view. The example recites that Charles makes his contribution to CharDor Partners with a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery deductions schedule (although its remaining economic life is significantly longer), but it does not clarify whether Charles has any knowledge of Doreen’s tax status. The example does not tell us that Charles understands that Doreen has a net operating loss or that she may be indifferent to the allocation of the gain from sale. The example does not tell us that Charles understands much at all about taxation, depreciation or partnership taxation. The example also does not tell us whether a $4,000 shift from one partner to another is material by comparison to the tax liabilities of Charles and Doreen. The example does not tell us how to judge materiality – or even whether materiality is material. There is not enough in the Treasury Regulations to permit us to formulate a durable, analytical structure that would permit us to apply the teaching of the example to another situation.

The example does not substantively discuss the anti-abuse rule as applied to the facts of the example. This example does not consider whether the shifting substantially reduces the present value of the partners’ aggregate tax liability. It never considers in a rigorous way whether any shifting of tax liabilities is material – or what “substantially reduce the present value of the partners’ aggregate tax liability” means. The example never addresses whether the allocation was “made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners’ aggregate tax liability.” The only view that the example identifies was “a view to taking advantage of the fact that the equipment has only one year remaining on its cost recovery schedule although its remaining economic life is significantly longer.” The example nevertheless concludes that the anti-abuse rule applies.

This example is difficult to reconcile with the “value equals basis” rule of the Section 704(b) Treasury Regulations. This rule states: “For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs

958 Treas. Reg. § 1.704-3(a)(10).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. The “value equals basis” rule would assume that the decline in value in the Section 704(c) property is real. This rule perhaps does not technically apply for purposes of the Section 704(c)(1)(A) Treasury Regulations, but, since the “value equals basis” rule is used to judge substantially, we might expect that it would be considered under the anti-abuse rule in the Section 704(c)(1)(A) Treasury Regulations on account of the parallelism between substantiality and the Section 704(c)(1)(A) anti-abuse rule. The Treasury Regulations could have done a much better job clarifying the relationship between substantiality and the Section 704(c)(1)(A) anti-abuse rule.

The example concludes that (under these facts) if the partnership agreement in effect for the year of contribution had provided that tax gain from the sale of the property (if any) would always be allocated first to Charles to offset the effect of the ceiling rule limitation, the allocation method would not violate the anti-abuse rule. Under other facts (for example, if the partnership holds multiple Section 704(c) properties and either uses multiple allocation methods or uses a single allocation method where one or more of the properties are subject to the ceiling rule), the allocation to Charles may not be reasonable.

n. Partnership Termination.

A partnership will terminate for tax purposes if a sale or exchange of a 50% or greater interest in capital and income occurs within a one-year period. The termination is treated as the contribution of property to a new partnership by the old partnership, followed by a distribution of partnership interests in the new partnership to the partners of the partnership, as constituted after the termination. Property deemed contributed to a new partnership as the result of the tax termination of a partnership is treated as Section 704(c) property in the hands of the new partnership only to the extent that the property was Section 704(c) property in the hands of the terminated partnership immediately prior to the termination. This means that the tax termination of a partnership does not automatically create

960 Id.
lots of Section 704(c) property. Property that was Section 704(c) property in the hands of the terminated partnership will continue as Section 704(c) property in the hands of the new partnership. Property that was not Section 704(c) property in the hands of the old partnership will not be converted into Section 704(c) property by the tax termination of the partnership.\textsuperscript{963}

Example 11. In Example 9, Laura sells her one-half interest in the Laurielle partnership to Kelly. This transfer of a 50 percent interest in the profits and capital of the Laurielle partnership cause it to terminate for federal income tax purposes.

The termination of Laurielle will cause Kelly to be treated as the contributor of the Section 704(c) property contributed to Laurielle by Laura. Other property of Laurielle that was not Section 704(c) property at the time of the termination will not become Section 704(c) property on account of the termination.

o. Multiple Methods.

Treasury Regulations permit a partnership to use different methods of applying Section 704(c)(1)(A) with respect to different items of contributed property. This general rule is subject to two limitations:

- The partnership and the partners must consistently apply a single reasonable method for each item of contributed property, and

- The overall method or combination of methods must be reasonable based on the facts and circumstances and consistent with the purpose of Section 704(c).\textsuperscript{964}

Treasury Regulations warn that it may be unreasonable for the partnership to use one method for appreciated property and another method for depreciated property. This presumably translates into: the partnership’s methods can be challenged by the IRS if a significant tax advantage exists in applying one method for appreciated property and another method for depreciated property.\textsuperscript{965}

Treasury Regulations also warn that Treasury Regulations clarify that it may be unreasonable for a partnership to use the traditional method for built-in gain property contributed by a partner with a high marginal tax rate while using curative allocations for built-in gain property contributed by a partner with a low marginal tax rate.\textsuperscript{966} This again is a warning that the method may be unreasonable.

\textsuperscript{963} Treas. Reg. § 1.704-3(a)(3)(i).
\textsuperscript{964} Treas. Reg. § 1.704-3(a)(2).
\textsuperscript{965} Id.
\textsuperscript{966} Treas. Reg. § 1.704-3(a)(2).
when it produces unduly taxpayer-favorable results. As a matter of practice, relatively few partnerships experiment with different methods of applying Section 704(c)(1)(A). Most practitioners are doing well if they can apply the traditional method properly.

p. Transfer of Partnership Interest.

A partner may transfer his partnership interest to another partner. This requires the partnership to allocate built-in gain or built-in loss to the transferee partner as it would have been allocated to the transferor partner. The transferee partner can inherit the transferring partner’s Section 704(c)(1)(A) problems. This becomes an important issue in negotiating a sale of a partnership interest. Built-in gain or built-in loss is prorated between the transferor and transferee partners proportionate to the interest transferred if the contributing partner transfers a portion of his partnership interest. The Treasury Regulations also clarify that a partnership making adjustments under Treasury Regulations Section 1.743-1(b) or Treasury Regulations Section 1.751-1(a)(2) must account for built-in gain or loss under Section 704(c)(1)(A) in accordance with the general principles set forth in the Section 704(c)(1)(A) regulations. Basis adjustments under Section 743 typically will not fully eliminate the effects of difference between asset value and adjusted tax basis.

Items allocated to the transferee partner under Section 743 may mitigate the effects of the Section 704(c) rules. Section 743 typically does not fully correct the problem for the transferee partner. Section 743 normally will correct problems of Section 704(c) property when the property is sold by the partnership at a gain. The recovery life of the Section 743 adjustment will not correspond to the recovery life of the underlying property as actually depreciated by the partnership. The annual cost recovery of the Section 743 adjustment often will not fully offset the income inclusion to the transferee partner resulting under Section 704(c)(1)(A), even when the transferee partner purchases the partnership interest for full fair market value. This is an important factor for purchasers to consider when negotiating the purchase of a partnership interest.

A new partnership formed as the result of the termination of a partnership under Section 708(b)(1)(B) is not required to use the same method as the terminated partnership, with respect to Section 704(c) property deemed contributed to

---

967 Treas. Reg. § 1.704-3(a)(7). This rule does not apply to any person who acquired a partnership interest from a § 1.752-7 liability partner in a transaction to which Treas. Reg. § 1.752-7(e)(1) applies.

968 Treas. Reg. § 1.704-3(a)(5).
the new partnership by the terminated partnership under Treasury Regulations Section 1.708-1(b)(1)(iv). 969

A special tax rate is imposed under Section 1(h) on the sales of intangibles and Section 1250 gain. Section 1(h) provides maximum capital gains rates in three categories: 15-percent rate gain, 25-percent rate gain, and 28-percent rate gain. Fifteen percent rate gain is net capital gain from the sale or exchange of capital assets held for more than one year, reduced by the sum of 25-percent rate gain and 28-percent rate gain. Twenty-five percent rate gain is limited to unrecaptured section 1250 gain. Twenty-eight percent rate gain includes capital gains and losses from the sale or exchange of collectibles 970 held for more than one year and certain other types of gain. These rules are applied to sales of partnership interests on a look-through basis. Capital gain attributable to the sale or exchange of an interest in a partnership held for more than one year generally is in the 15-percent rate gain category. When a taxpayer sells or exchanges an interest in a partnership that holds collectibles, rules similar to the rules under Section 751(a) apply to determine the capital gain that is attributable to certain unrealized gain in the collectibles. Rules similar to the rules under Section 751(a) also apply to determine the capital gain attributable to certain unrealized gain in section 1250 property held by a partnership when a taxpayer sells or exchanges an interest in a partnership that holds such property. Proposed regulations provide: “Certain commentators requested that the final regulations provide guidance with respect to the proportionate part of the section 704(c) built-in gain or loss that is transferred to the purchaser when a section 704(c) partner sells a portion of a partnership interest. This issue is relevant because, in determining a taxpayer’s share of collectibles gain or section 1250 capital gain on the sale of a partnership interest, it is necessary to calculate how much of such gain would be allocated with respect to the partnership interest sold if the underlying collectibles or section 1250 property held by the partnership were sold for their fair market value. In making this determination where a partner sells only a portion of its interest in a partnership, it is necessary to determine how much section 704(c) gain relating to collectibles or section 1250 property is allocable to the portion of the partnership interest that is sold. Although relevant, Treasury and the IRS believe that this issue is beyond the scope of these regulations. Accordingly, this comment is not addressed in these regulations.”971

969 Treas. Reg. § 1.704-3(a)(2).
970 As defined in I.R.C. § 408(m) without regard to I.R.C. § 408(m)(3).
q. Reverse Section 704(c) Allocations.

Principles of Section 704(c)(1)(A) apply to revaluations of partnership property on permitted events. Revaluations ultimately will result in “reverse Section 704(c) allocations” when principles of Section 704(c)(1)(A) are applied to the revaluation gain or the revaluation loss. Regulations could have provided considerably greater detail on precisely how this works. Regulations clarify that a partnership is not required to use the same allocation method for reverse Section 704(c) allocations that the partnership used for contributed property. Partnerships are not required to use the same allocation method for reverse Section 704(c) allocations each time that the partnership revalues its property. The partnership may use any permitted method of applying Section 704(c)(1)(A). Determining reverse Section 704(c) allocations is outside of the scope of this Article.\(^{972}\)

r. Nonrecognition Exchanges of Section 704(c) Property.

Treasury Regulations also contain rules where the partnership disposes of Section 704(c) property in a nonrecognition transaction. The substituted basis property that the partnership receives in the exchange becomes Section 704(c) property in the hands of the partnership. The substituted basis property will have the same amount of built-in gain or built-in loss as the Section 704(c) property that the property transferred in the exchange. This rule is important when the partnership transfers property to a subsidiary partnership or when the partnership transfers property in a Section 1031 like-kind exchange. Gain or loss recognized in the nonrecognition transaction should cause the partnership to make “appropriate adjustments.” Treasury Regulations require that the allocation method that the partnership uses for the substituted basis property must be “consistent” with the allocation method chosen for the original property. This typically will mean that the partnership will use the same method for the substituted basis property as it used for the transferred property. That, however, is not what Treasury Regulations literally require. Treasury Regulations do not clarify what “consistent” means in this context. Treasury Regulations appear to use “consistent” in this context as “the same as.”\(^{973}\)

The partnership can dispose of Section 704(c) property in a nonrecognition exchange under Section 1031. The partnership may receive multiple replacement properties in the exchange. The Section 704(c) Treasury Regulations do not identify how built-in gain in the relinquished property is allocated between

\(^{972}\) Treas. Reg. § 1.704-3(a)(6)(i).

\(^{973}\) Treas. Reg. § 1.704-3(a)(8)(i). The Treasury Regulations do not clarify how the partnership accounts for multiple properties acquired in an exchange.
multiple replacement properties. In an exchange of multiple properties qualifying for nonrecognition of gain or loss under Section 1031, the aggregate adjusted tax basis of properties received in each of the exchange groups is (i) the aggregate adjusted tax basis of the properties transferred by the taxpayer within that exchange group, increased by (ii) the amount of gain recognized by the taxpayer with respect to that exchange group, increased by (iii) the amount of the exchange group surplus or decreased by (iv) the amount of the exchange group deficiency, and increased by (v) the amount, if any, of excess liabilities assumed by the taxpayer that are allocated to that exchange group. The resulting aggregate adjusted tax basis of each exchange group is allocated proportionately to each property received in the exchange group in accordance with its fair market value.\textsuperscript{974} The adjusted tax basis of each property received within the residual group (other than money) is equal to its fair market value.\textsuperscript{975} It seems reasonably plausible that Section 704(c) gain or loss should be allocated among replacement properties in the same manner.

A partnership may transfer Section 704(c) property together with other property to a corporation under Section 351. Treasury Regulations require that the adjusted tax basis in the stock received in exchange for the Section 704(c) property is determined as if each item of Section 704(c) property had been the only property transferred to the corporation by the partnership.\textsuperscript{976}

Example 12. In Example 9, the Laurielle partnership transfers the land and building contributed by Laura in a Section 1031 exchange. At the time of the exchange, the fair market value of the building is $1 million and its adjusted tax basis is $600,000; the built-in gain is $400,000. The improvements have a fair market value of $2 million and an adjusted tax basis of $1,600,000; the built-in gain is $400,000. The replacement property is both property 1 (a building with a fair market value of $2,300,000 and land with a fair market value of $1,000,000) and property 2 (a building with a fair market value of $4,000,000 and land with a fair market value of $1,800,000). The aggregate fair market value of the replacement properties is $9,100,000. Laurielle acquires property 1 with $1,000,000 of exchange balance and $2,300,000 of partnership cash. Laurielle acquires property 2 (acquisition price, $5,800,000) with $2,000,000 of exchange balance, $700,000 of partnership cash, and $3,100,000 of new borrowings from a bank, secured by property 2.

All of the replacement property is in the same exchange group. The aggregate adjusted tax basis in the replacement property equals:

\textsuperscript{974} Treas. Reg. §1.1031(j)-1(c).
\textsuperscript{975} Id.
\textsuperscript{976} Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Carryover basis from relinquished property | $2,200,000
New cash from cash available | $3,000,000
New cash from borrowing | $3,100,000
Total | $8,300,000

This $8,300,000 of adjusted tax basis in the replacement properties should be allocated among the four replacement properties in accordance with the ratio of fair market values:

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Percent of Fair Market Value</th>
<th>Basis Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building 1</td>
<td>$2,300,000</td>
<td>25.274725%</td>
</tr>
<tr>
<td>Land 1</td>
<td>$1,000,000</td>
<td>10.989011%</td>
</tr>
<tr>
<td>Building 2</td>
<td>$4,000,000</td>
<td>43.956044%</td>
</tr>
<tr>
<td>Land 2</td>
<td>$1,800,000</td>
<td>19.780220%</td>
</tr>
<tr>
<td>Total</td>
<td>$9,100,000</td>
<td>100.000000%</td>
</tr>
</tbody>
</table>

This much is firmly based on Treasury Regulations under Section 1031.

A similar methodology could be applied in allocating the Section 704(c) built-in gain. There is $800,000 in Section 704(c) built-in gain in the property contributed by Laura. This shows the computation of the possible allocation of the built-in gain to the replacement property:

<table>
<thead>
<tr>
<th>Fair Market Value</th>
<th>Percent of Fair Market Value</th>
<th>Basis Allocation</th>
<th>( \Delta )</th>
<th>Build-in Gain Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building 1</td>
<td>$2,300,000</td>
<td>25.274725%</td>
<td>$2,097,802</td>
<td>$202,198</td>
</tr>
<tr>
<td>Land 1</td>
<td>$1,000,000</td>
<td>10.989011%</td>
<td>$912,088</td>
<td>$87,912</td>
</tr>
<tr>
<td>Building 2</td>
<td>$4,000,000</td>
<td>43.956044%</td>
<td>$3,648,352</td>
<td>$351,648</td>
</tr>
<tr>
<td>Land 2</td>
<td>$1,800,000</td>
<td>19.780220%</td>
<td>$1,641,758</td>
<td>$158,242</td>
</tr>
<tr>
<td>Total</td>
<td>$9,100,000</td>
<td>100.000000%</td>
<td>$8,300,000</td>
<td>$800,000</td>
</tr>
</tbody>
</table>

Some advisors may argue that a more sensible allocation might be based on implicit principles of MACRS regulations that apply to exchanges. Rules of Temporary Treasury Regulations 1.168(i)-6T teach us that if land or other nondepreciable property is acquired in a like-kind exchange for depreciable property, the land or other nondepreciable property is not depreciated. If both MACRS and nondepreciable property are acquired in a like-kind exchange for MACRS property, the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is treated as though the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement.
The depreciation allowances for the replacement MACRS property are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. Some advisors believe that this methodology implicitly requires matching basis of relinquished MACRS property to the basis of new replacement MACRS property and matching the basis of relinquished land to replacement land (in both cases, to the extent possible under the multi-asset exchange basis rules). This view is not firmly grounded on the language of either the Code or Treasury Regulations.

It nevertheless is not clear precisely how these rules apply to an exchange. The Treasury Regulations themselves are not explicit. A critical question is what basis from MACRS property is allocated to which replacement property. There is an inclination to want to allocate basis from old MACRS property to replacement MACRS property and to allocate basis from old land to new land, at least to the extent reasonably practical (as limited by the Section 168 Treasury Relations). Otherwise, basis from relinquished MACRS property may be allocated in part to replacement land. This reasoning suggests that we should try to match Section 704(c) built-in gain from contributed land with replacement land and Section 704(c) built-in gain from contributed improvements with replacement improvements. The Treasury Regulations, however, do not provide clear guidance on making such an allocation. It is doubtful that the issues will be clarified before either the IRS issues guidance or the situation is resolved in the courts. A sensible scheme might try to match Section 704(c) gain from relinquished MACRS property to replacement MACRS property and relinquished land to replacement land (to the extent reasonably possible and consistent with the basic basis allocation regulation).

s. Installment Sale.

A partnership may dispose of Section 704(c) property in an installment sale and report its gain under the installment obligation. The installment obligation is treated as Section 704(c) property with the same amount of built-in gain as the Section 704(c) property disposed of by the partnership (with appropriate adjustments for any gain recognized on the installment sale). The partnership will

---

978 Treas. Reg. §1.1031(j)-1(c).
979 Treas. Reg. §1.1031(j)-1(c).
980 This rule is important to counter certain arguably abusive tax shelter plans that depended on avoiding disguised sale rules through sale of partnership property for an installment obligation, followed by distribution of the obligation in redemption of a high tax basis partner or a tax indifferent partner.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

deal with recognized gain under Section 704(c)(1)(A) as it receives payments on the installment note. The allocation method for the installment obligation must be “consistent” with the allocation method chosen for the original property. This may well mean that the partnership must use the same allocation method for applying Section 704(c)(1)(A) to payments on the installment obligation that the partnership would have used for regular payments on the sale of the Section 704(c) property.  


Example 13 illustrates a possible attempt to avoid the disguised sale rules of Section 704(c)(1)(B). The distribution of the land contributed by Greg to Stanley would cause the disguised sale rules to apply. Greg may believe that converting the contributed land to an installment obligation and distributing the installment obligations may avoid the application of the disguised sale rules. The Treasury Regulations counter this approach by treating the installment obligation as Section 704(c) property with the same amount of built-in gain as the Section 704(c) property disposed of by the partnership in the installment sale (with appropriate adjustments for any gain recognized on the installment sale). The distribution of the installment obligation will be treated for purposes of the disguised sale rules as a distribution of the contributed land. The disguised sale rules will tax Greg on the Section 704(c) gain in the contributed land (as transferred to the installment obligations).

t. Option as Section 704(c) Property.

A partner might contribute to a partnership an appreciated option to acquire property, or another contract to acquire property that is Section 704(c) property. The partnership then might subsequently acquire property pursuant to the contract in a transaction in which less than all of the gain or loss is recognized, such as an exercise of the option of a purchase pursuant to the contract. The ac-

---

981 Treas. Reg. § 1.704-3(a)(8)(i).
982 This rule is important to counter certain arguably abusive tax shelter plans that depended on avoiding disguised sale rules through sale of partnership property for an installment obligation, followed by distribution of the obligation in redemption of a high tax basis partner or a tax indifferent partner.
required property is treated as the Section 704(c) property with the same amount of built-in gain or loss as the contract (with appropriate adjustments for any gain or loss recognized on the acquisition).

This provision applies to –

- Options,
- Forward contracts,
- Futures contracts, and
- Other contracts to acquire property.

The allocation method for the acquired property must be “consistent” with the allocation method chosen for the contributed contract. Again, it is possible that “consistent” in this context means “the same as” – but Treasury Regulations do use the terminology “consistent.”

u. Long-term Contracts Method.

A partner can contribute to a partnership a contract that the partner is accounting for under the completed contracts method or the percentage of completion contract method. Treasury Regulations provide mid-contract transfer rules that require that the principles of Section 704(c)(1)(A) apply to income or loss with respect to a contract accounted for under a long-term contract method of accounting that is contributed to a partnership. Mid-contract transfer rules of Treasury Regulations Section 1.460-4(k) apply whenever (prior to the completion of a long-term contract accounted for using a long-term contract method by a taxpayer (old taxpayer)) there is a transaction that makes another taxpayer (new taxpayer) responsible for accounting for income from the same contract. An old taxpayer also includes any old taxpayer (for example, predecessors) of the old taxpayer. A contract will be treated as the same contract if the terms of the contract are not substantially changed in connection with the transaction. This applies whether or not the customer agrees to release the old taxpayer from any or all of its obligations under the contract.

On a contribution of a contract accounted for under the completed contracts method or the percentage of completion contract method to a partnership, the partnership (the new taxpayer) will “step into the shoes” of the contributing partner (the old taxpayer) with respect to the contract. The contributing partner’s obligation to account for the contract terminates on the date of the contribution.

---

transaction. This obligation to account for the contract is assumed by the partnership.\footnote{986 Treas. Reg. § 1.460-4(k)(3)(iii)(A).}

A contributing partner using the percentage of completion method is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction.\footnote{987 Treas. Reg. § 1.460-4(k)(3)(iii)(A).}

A contributing partner using the completed contracts method is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.\footnote{988 Treas. Reg. § 1.460-4(k)(3)(iii)(A).}

The amount of gain that the contributing partner realizes on the transfer of a contract in a step-in-the-shoes transaction is determined (after application of Treasury Regulations Section 1.460-4(k)(3)(ii)(A)) using the rules of Treasury Regulations Section 1.460-4(k)(2) that apply to constructive completion transactions.\footnote{989 Treas. Reg. § 1.460-4(k)(2)(i).} The contributing partner is treated as completing the contract on the date of the transaction. The total contract price (or, gross contract price in the case of a long-term contract accounted for under the completed contracts method) for the contributing partner is the sum of any amounts realized from the transaction that are allocable to the contract and any amounts the contributing partner has received or reasonably expects to receive under the contract. Total contract price (or gross contract price) is reduced by any amount paid by the contributing partner to the partnership, and by any transaction costs, that are allocable to the contract. The contributing partner's allocable contract costs do not include any consideration paid (or costs incurred) as a result of the contribution transaction that are allocable to the contract.\footnote{990 Treas. Reg. § 1.460-4(k)(2)(ii).}

Beginning on the date of the contribution of the contract to the partnership, the partnership must account for the long-term contract by using the same method of accounting used by the contributing partner prior to the contribution transaction. If the contributing partner uses the percentage of completion method to account for the contract, the partnership steps into the shoes of the contributing partner with respect to its completion factor and percentage of completion methods (such as the 10-percent method), even if the partnership has not elected such methods for similarly classified contracts. If the contributing partner uses the completed contracts method, the partnership steps into the shoes of the contributing partner with respect to the completed contracts method, even if the part-
ship is not otherwise eligible to use the completed contracts method. The partnership is not necessarily bound by the contributing partner’s method for similarly classified contracts entered into by the partnership subsequent to the transaction and must apply general tax principles to determine the appropriate method to account for these subsequent contracts. To the extent that general tax principles allow the taxpayer to account for similarly classified contracts using a method other than the contributing partner’s method, the taxpayer is not required to obtain the consent of the Commissioner to begin using such other method.\textsuperscript{991}

In the case of a long-term contract that has been accounted for under percentage of completion method, the total contract price for the partnership is the sum of any amounts the contributing partner or the partnership has received (or reasonably expects to receive under the contract). Similarly, the gross contract price in the case of a long-term contract accounted for under the completed contracts method includes all amounts the contributing partner or the partnership is entitled by law or by contract to receive.\textsuperscript{992}

Total allocable contract costs for the partnership are the allocable contract costs incurred by either the contributing partner prior to, or the partnership after, the transaction. Any payments between the contributing partner and the partnership with respect to the contract in connection with the transaction are not treated as allocable contract costs.\textsuperscript{993}

This method is used to determine the amount of built-in income or built-in loss attributable to a contributed contract that is subject to Section 704(c)(1)(A):

- First, the contributing partner must take into account any income or loss required for the period ending on the date of the contribution.\textsuperscript{994} An old taxpayer using the percentage of completion method is required to recognize income from the contract based on the cumulative allocable contract costs incurred as of the date of the transaction. Similarly, an old taxpayer using the completed contracts method is not required to recognize any revenue and may not deduct allocable contract costs incurred with respect to the contract.\textsuperscript{995}

- Second, the partnership must determine the amount of income or loss that the contributing partner would take into account if the

\textsuperscript{991} Treas. Reg. § 1.460-4(k)(3)(iii)(A).
\textsuperscript{992} Treas. Reg. § 1.460-4(k)(3)(iii)(B);
\textsuperscript{993} Treas. Reg. § 1.460-4(k)(3)(iii)(C).
\textsuperscript{994} Treas. Reg. § 1.460-4(k)(3)(v)(1).
\textsuperscript{995} Treas. Reg. § 1.460-4(k)(3)(ii)(A).
contract were disposed of for its fair market value in a constructive completion transaction. This calculation is treated as occurring immediately after the partner has applied Treasury Regulations Section 1.460-4(k)(3)(ii)(A), but before the contribution to the partnership.  

- Finally, this amount is reduced by the amount of income (if any) that the contributing partner is required to recognize as a result of the contribution.

In the case of a contract accounted for under the completed contracts method, any built-in income or loss under Section 704(c) is taken into account in the year the contract is completed. In the case of a contract accounted for under a long-term contract method of accounting other than the completed contracts method, any built-in income or loss under Section 704(c) must be taken into account in a manner that reasonably accounts for the Section 704(c) income or loss over the remaining term of the contract.

v. Capitalized Amounts and Contingent Liabilities.

To the extent that a partnership properly capitalizes all or a portion of an item under the rules of Treasury Regulations Section 704-3(a)(12) [considering contingent liabilities under Treasury Regulations Section 1.752-7], then the item or items to which the cost is properly capitalized is treated as Section 704(c) property with the same amount of built-in loss as corresponds to the amount capitalized. The Treasury Regulations also provide that: “Except as otherwise provided in 51.752-7, § 1.752-7 liabilities (within the meaning of § 1.752-7(b)(2)) are section 704(c) property (built-in loss property that at the time of contribution has a book value that differs from the contributing partner’s adjusted tax basis) for purposes of applying the rules of this section. See § 1.752-7(c). To the extent that the built-in loss associated with the § 1.752-7 liability exceeds the cost of satisfying the § 1.752-7 liability (as defined in § 1.752-7(b)(3)), the excess creates a “ceiling rule” limitation, within the meaning of § 1.704-3(b)(1), subject to the methods of allocation set forth in § 1.704-3(b), (c) and (d).”

The complex subject of Section 1.752-7 liabilities is outside of the scope of this Article.

1000 Treas. Reg. § 1.704-3(a)(12).
w. Tiered partnerships.

An upper-tier partnership (a “parent partnership”) may contribute Section 704(c) property to a second partnership (the “lower-tier partnership”) in which the upper-tier partnership owned an interest. A partner that has contributed Section 704(c) property to a partnership may contribute that partnership interest to a second partnership (the upper-tier partnership). In either case, Treasury Regulations require that the upper-tier partnership must allocate its distributive share of lower-tier partnership items with respect to that Section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss.\footnote{1001}{Treas. Reg. § 1.704-3(a)(9).} Allocations made under this rule will be considered to be made in a manner that meets the requirements of Treasury Regulations Section 1.704-1(b)(2)(iv)(q) (relating to capital account adjustments where guidance is lacking).\footnote{1002}{See discussion in text beginning at 926.}

Example 14. Bathsheba and Balthazar form the Bathar partnership. Bathsheba contributes land with a fair market value of $300,000 and an adjusted tax basis of $100,000 and improvements with a fair market value of $700,000 and an adjusted tax basis of $350,000 to Bathar. Bathsheba receives a 25% interest in the income and capital of the Bathar partnership. Balthazar contributes $3,000,000 in cash to the Bathar partnership. Bathsheba receives a 75% interest in the capital, income, and losses of the Bathar partnership. All “book” income, gain, depreciation, and loss are allocated in accordance with these percentages. Bathar contributes the land and improvements to Subco, a subsidiary partnership, and receives a 30% interest in the capital, profits, and losses of Subco.

Bathar’s interest in Subco should be treated as Section 704(c) property, since it is substituted basis property received for the land and improvements. The land and improvements are Section 704(c) property in Subco’s hands. The upper-tier partnership, Bathar, must allocate its distributive share of lower-tier (Subco) partnership items with respect to that Section 704(c) property in a manner that takes into account the contributing partner’s (Bathsheba’s) remaining built-in gain or loss.\footnote{1003}{Treas. Reg. § 1.704-3(a)(9).} Subco should allocate future depreciation and gain and loss with respect to the contributed land and improvements in accordance with Section 704(c)(1)(A). Bathar similarly should allocate this future depreciation and gain and loss that flow through from Subco in accordance with Section 704(c)(1)(A). It nevertheless is not clear what happens if Subco uses the remedial allocation method but Bathar uses the traditional method. It would seem
that Bathsheba should be subject to the effects of the remedial method if Subco uses the remedial allocation method.

Example 15. In Example 15, Bathsheba contributes her interest in Bathar to Top Hat Partners.

The interest in Bathar is treated as Section 704(c) property in the hands of Top Hat Partners. The upper-tier partnership, Top Hat Partners, must allocate its distributive share of lower-tier partnership items (the items with respect to the contributed land and improvements) with respect to that Section 704(c) property in a manner that takes into account the contributing partner’s remaining built-in gain or loss.

x. **Aggregation**

Aggregation of assets generally is not permitted for purposes of Section 704(c)(1)(A) computations. Limited aggregation, however, is permitted under specified circumstances set forth in the Treasury Regulations. Each of the following types of property may be aggregated for purposes of making allocations under Section 704(c) if contributed by one partner during the partnership taxable year:

- Depreciable property. This applies to all property (other than real property) that is included in the same general asset account of the contributing partner and the partnership under Section 168.\(^{1004}\)

- Zero-basis property. All property with a basis equal to zero (other than real property).\(^{1005}\)

- Inventory. For partnerships that do not use a specific identification method of accounting, each item of inventory (other than qualified financial assets).\(^{1006}\)

This aggregation requires that the property be contributed by one partner during the partnership taxable year by one partner. It is not entirely clear what happens if the partner committed to contribute various assets during the taxable year by more than one partner. The concept is further expanded in the Treasury Regulations for management companies, and for partnership interests., and for partnership interests,

---

\(^{1004}\) Treas. Reg. § 1.704-3(a)(9).

\(^{1005}\) Treas. Reg. § 1.704-3(e)(2)(i).

\(^{1006}\) Treas. Reg. § 1.704-3(e)(2)(ii).

\(^{1007}\) Treas. Reg. § 1.704-3(e)(2)(iii). Treas. Reg. § 1.704-3(e)(3)(ii)(A) ("A qualified financial asset is any personal property (including stock) that is actively traded. Actively traded means actively traded as defined in section 1.1092(d)-1 (defining actively traded property for purposes of the straddle rules)."). The concept is further expanded in the Treasury Regulations for management companies, and for partnership interests., and for partnership interests.
year but some assets were actually contributed during one year and other assets were contributed during the next.

Other aggregation is permitted for securities partnerships. This subject is outside of the scope of this Article.

140. Substantial Economic Effect.

Allocations of income or loss in a partnership agreement are not necessarily respected. Allocations generally must meet the standard of having “substantial economic effect.” The basic premise of substantial economic effect is that the partner who receives income allocations should receive the corresponding economic benefits and the partner who receives loss allocations should bear the corresponding economic detriments. The rules of substantial economic effect give economic credibility to the partners’ capital accounts.

Treasury Regulations prescribe a two-stage analysis. The allocation first must satisfy the rules of economic effect. This generally implies a capital account analysis and ensures that capital accounts reflect the true economic deal at liquidation (although interim capital accounts may look different from the overall economic deal). The allocation additionally must pass the filter of substantiality. Substantiality involves a mathematical present value analysis of benefits and burdens of the allocation. An allocation the fails to have substantial economic effect nevertheless will be respected if the allocation is “in accordance with the partner’s interest in the partnership.” The filter of “in accordance with the partner’s interest in the partnership” is a less precise, holistic filter than the filter of substantial economic effect. The filter of “in accordance with the partner’s interest in the partnership” is more difficult to apply with confidence than the filter of substantial economic effect.

The discussion that follows is merely a basic overview of the substantial economic effect rules that apply to partnership allocations. The rules in their glorious detail are bewilderingly complex, so complex indeed that one questions whether the draftsmen of Treasury Regulations had any idea of how the rules would be applied in practice. Some of the rules seem to be more theoretical guidelines than practical rules meant to be applied with real numbers. The rules of sub-

1008 Treas. Reg. § 1.704-3(e)(3).
1009 I.R.C. § 704(b).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Substantial economic effect show signs of tax law complexity driven by such intense concern about abuse that the result is a scheme that perhaps no one can apply rigorously.

Five classes of allocations are not subject to the substantial economic effect rules:

- Nonrecourse deductions.\(^{1013}\)
- Partner nonrecourse deductions.\(^{1014}\)
- Minimum gain chargeback allocations.\(^{1015}\)
- Partner nonrecourse debt minimum gain chargeback allocations.\(^{1016}\)
- Qualified income offset allocations.\(^{1017}\)

Your partnership agreement\(^ {1018}\) may not provide for the allocation of in-

\(^{1013}\) Treas. Reg. § 1.704-2(b)(1), (c).
\(^{1014}\) Treas. Reg. § 1.704-2(i).
\(^{1015}\) Treas. Reg. § 1.704-2(d), (f), (g).
\(^{1016}\) Treas. Reg. § 1.704-2(i)(4).
\(^{1017}\) Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\(^{1018}\) Treas. Reg. § 1.704-1(b)(2)(ii)(h) (“Partnership agreement defined. For purposes of this paragraph, the partnership agreement includes all agreements among the partners, or between one or more partners and the partnership, concerning affairs of the partnership and responsibilities of partners, whether oral or written, and whether or not embodied in a document referred to by the partners as the partnership agreement. Thus, in determining whether distributions are required in all cases to be made in accordance with the partners’ positive capital account balances (requirement (2) of paragraph (b)(2)(ii)(b) of this section), and in determining the extent to which a partner is obligated to restore a deficit balance in his capital account (requirement (3) of paragraph (b)(2)(ii)(b) of this section), all arrangements among partners, or between one or more partners and the partnership relating to the partnership, direct and indirect, including puts, options, and other buy-sell agreements, and any other ‘stop-loss’ arrangement, are considered to be part of the partnership agreement. (Thus, for example, if one partner who assumes a liability of the partnership is indemnified by another partner for a portion of such liability, the indemnifying partner (depending upon the particular facts) may be viewed as in effect having a partial deficit makeup obligation as a result of such indemnity agreement.) In addition, the partnership agreement includes provisions of Federal, State, or local law that govern the affairs of the partnership or are considered under such law to be a part of the partnership agreement” (footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

come, gain, loss, deduction, or credit (or item thereof) to a partner. Then, the partner’s distributive share of the income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the “partners’ interests in the partnership” (taking into account all facts and circumstances). The filter of “in accordance with the partner’s interest in the partnership” is an imprecise filter. This filter apparently looks principally to the economics of the arrangement. This filter in most cases looks at the effects of the allocation on partners’ capital accounts and looks to how cash would be distributed on [hypothetical] liquidation of the partnership. The filter asks how income and loss items should be allocated so that, if the partnership is liquidated in accordance with the liquidation provision in the partnership agreement, the distribution would liquidate in accordance with capital accounts.

The rules of economic effect apply to “book” allocations. The substantial economic effect rules, when there is a disparity between “book” value and tax basis, disregard the tax basis of the property. Taxable income is not at all considered when testing for economic effect. This is an additional reason for drafting allocations based on “book” income and loss rather than on taxable income and loss.

Your partnership agreement may provide for the allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner. An allocation may not have substantial economic effect. Then, the partner’s distributive share of the income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner’s interest in the partnership (taking into account all facts and circumstances) (sometimes referred to as “PIP”).

The tax rules governing partnership allocations (Section 704(b)) can respect an allocation of income, gain, loss, deduction, or credit (or item thereof) to a partner under any of three alternative standards:

• The allocation can have substantial economic effect.
• Taking into account all facts and circumstances, the allocation can be in accordance with the partner’s interest in the partnership.

(see the last sentence of paragraph (c) of section 1.761-1). For purposes of this paragraph (b)(2)(ii)(h), an agreement with a partner or a partnership shall include an agreement with a person related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to such partner or partnership. For purposes of the preceding sentence, sections 267(b) and 707(b)(1) shall be applied for partnership taxable years beginning after December 29, 1988 by (1) substituting ‘80 percent or more’ for ‘more than 50 percent’ each place it appears in such sections, (2) excluding brothers and sisters from the members of a person’s family, and (3) disregarding section 267(f)(1)(A).”)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The allocation can be treated as in accordance with the partner’s interest in the partnership under one of the special exceptions concerning partners’ interest in the partnership.

The income, gain, loss, deduction, or credit (or item thereof) will be reallocated in accordance with the partner’s interest in the partnership to the extent that the allocation does not have substantial economic effect, is not in accordance with the partner’s interest in the partnership, and is not treated as being made in accordance with the partner’s interest in the partnership.

The determination of a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) under the tax rules governing partnership allocations (Section 704(b)) is not conclusive. An allocation of loss or deduction to a partner that is respected under the partnership rules governing partnership allocations (Section 704(b)) may not be deductible by the partner if the partner lacks the requisite motive for economic gain (Goldstein v. Commissioner\textsuperscript{1019}), or may be disallowed for that taxable year (and held in suspense) if the at risk limitations of Section 465 or the basis limitations of Section 704(d) or the passive loss rules of Section 469 apply. The rules for reallocation of items among commonly controlled entities under Section 482, the family partnership rules of Section 704(e)(2), the varying interests rules of Section 706(d) (and related assignment of income principles), and the collapsible partnership rules of Treasury Regulations Section 1.751-1(b)(2)(ii) can be used by the IRS to reallocate partnership allocations.\textsuperscript{1020}

There rules of substantial economic effect apply principally to deductions funded by capital contributions or by partnership liabilities when a partner has personal liability. Special rules apply to nonrecourse deductions. Special rules apply to partnership deductions attributable to nonrecourse liabilities guaranteed by a partner. The rules are uncertain when deductions are attributable to partnership liabilities that are fully recourse to a partnership but nonrecourse to all of the partners. These deductions are common for limited liability companies when liabilities are unlimited recourse to the entity but nonrecourse to the members.

\textsuperscript{1019} 364 F.2d 734 (2d Cir. 1966).

\textsuperscript{1020} For a discussion of I.R.C. § 751(b) generally, see Monte A. Jackel, “Blissful Ignorance: Section 751(b) Uncharted Territory,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Monte A. Jackel & Avery I. Stok, “Blissful Ignorance: Section 751(b) Uncharted Territory” 98 TAX NOTES, 1559-60 (March 10, 2003); Darryll K. Jones, “Simplifying Section 751(b): You Can’t Get There From Here,” 111 TAX NOTES 99 (Apr. 3, 2006).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

a. Economic Effect.

The filter of economic effect applies a capital account analysis. The rules are technical and are a tough slog. Learn these rules in order to draft effective allocations. Economic effect is balance sheet intensive. Your partnership must maintain balance sheet capital accounts in accordance with rules in Treasury Regulations. The amount that a partner ultimately receives from the partnership must depend on his capital account balance – liquidating distributions must zero-out capital accounts. A partner with a deficit capital account must repay to the partnership the amount of that deficit on the termination of his interest in the partnership. This accounting scheme must determine partnership economics.

The general principle of economic effect is that an allocation must have economic substance. The partner who receives the allocation of income or profit in circumstances, in which an allocation of income or profit has a corresponding economic benefit, should receive the economic benefit. The partner who receives the allocation of loss, when an allocation of loss has a corresponding economic detriment, should receive the economic detriment. This is essentially what the filter of economic effect ensures.

The allocation must be consistent with the underlying economic arrangement of the partners in order for an allocation to have economic effect: when there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive the economic benefit or bear the economic burden. This effect often is measured by the allocation’s effects on capital accounts and whether those capital accounts control partnership economics.

Consider the “value equals basis” rule. This rule essentially assumes that “book” depreciation is real, that there is economic depreciation in value that corresponds to tax or “book” depreciation.¹⁰²¹

¹⁰²¹ Treas. Reg. § 1.704-1(b)(2)(ii)(b) (“For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposi- (footnote continued on the next page)
b. Filters of Economic Effect.

An allocation has substantial economic effect if the partnership agreement passes three filters based on capital accounts:

... an allocation of income, gain, loss, or deduction (or item thereof) to a partner will have economic effect if, and only if, throughout the full term of the partnership, the partnership agreement provides—

(1) For the determination and maintenance of the partners’ capital accounts in accordance with the rules of paragraph (b)(2)(iv) of this section,

(2) Upon liquidation of the partnership (or any partner’s interest in the partnership), liquidating distributions are required in all cases to be made in accordance with the positive capital account balances of the partners, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (2) and requirement (3) of this paragraph (b)(2)(ii)(b)), by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), and

(3) If such partner has a deficit balance in his capital account following the liquidation of his interest in the partnership, as determined after taking into account all capital account adjustments for the partnership taxable year during which such liquidation occurs (other than those made pursuant to this requirement (3)), he is unconditionally obligated to restore the amount of such deficit balance to the partnership by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances (in accordance with requirement (2) of this paragraph (b)(2)(ii)(b)).

For purposes of the preceding sentence, a partnership taxable year shall be determined without regard to section 706(c)(2)(A). Requirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or sec-

---

(1102). See discussion of the “value equals basis” rule accompanying note 1102.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tion 707(b)(1), to a partner) pursuant to an agreement negotiated at arm’s length by persons who at the time such agreement is entered into have materially adverse interests and if a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section. In addition, requirement (2) of this paragraph (b)(2)(ii)(b) is not violated if, upon the liquidation of the partnership, the capital accounts of the partners are increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this section as of the date of such liquidation and the partnership makes liquidating distributions within the time set out in that requirement (2) in the ratios of the partners’ positive capital accounts, except that it does not distribute reserves reasonably required to provide for liabilities (contingent or otherwise) of the partnership and installment obligations owed to the partnership, so long as such withheld amounts are distributed as soon as practicable and in the ratios of the partners’ positive capital account balances. . . .

These requirements must be met “throughout the full term of the partnership.” Treasury Regulations do not contain a corrective mechanism if you ever have violated any of the rules. Once you have failed the filter, you have failed it forever.

c. Capital Account Maintenance.

The first requirement is that the partnership agreement requires that the partnership maintain capital accounts in accordance with Treasury Regulations concerning capital account maintenance. This perhaps is best achieved by using a definition of “capital account” that cross-references Treasury Regulations and by following those conventions in practice.1023

d. Liquidation in Accordance with Capital Accounts.

The second requirement is that capital accounts reflect partnership economics. This is usually achieved through a provision in the partnership agreement requiring distribution on liquidation in accordance with capital accounts. The manner in which capital accounts affect partnership economics is by capital accounts controlling liquidating distributions to partners. This applies regardless of whether the liquidating distribution is made on the liquidation of the individual partner or on the complete liquidation of the partnership itself. “Liquidation” is defined specially in Treasury Regulations:

1023 See discussion of capital account accounting in text at note 787.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(g) Liquidation defined. For purposes of this paragraph, a liquidation of a partner’s interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner’s interest in the partnership under paragraph (d) of section 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner’s interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner’s obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section.\textsuperscript{1024}

Treasury Regulations conceal nuances. A “liquidation” includes a constructive liquidation under Section 708: the sale or exchange of a 50% or greater interest in capital and profits within one year. Cross-reference the definition of “liquidation” in Treasury Regulations in order to capture this nuance: Treasury Regulations Section 1.704-1(b)(2)(iv)(g). Treasury Regulations require that liquidating distributions be made to the partner by the end of the taxable year of liquidation (or, if later, within 90 days after the date of the liquidation). The partnership is permitted to revalue capital accounts at the time of the liquidation. This gives the retiring partner the benefit of any appreciation in partnership assets.

Treasury Regulations contain this extraordinary qualification:

Requirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not violated if all or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership) by the partnership or by one or more partners (or one or more persons related, within the meaning of section 267(b) (without modification by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an agreement negotiated at arm’s length by persons who at the time such agreement is entered into have materially adverse interests and if a prin-

\textsuperscript{1024} Treas. Reg. § 1.704-1(b)(2)(iv)(g).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of this section.1025

The partnership is not always required to retire a partner with distributions that are equal to a retiring partner’s capital account. Just exactly when the capital account liquidation rule is relaxed is obscure.

The first point is petulant. The qualification in Treasury Regulations does not mean what it says; the qualification is badly drafted. The qualification states that “[r]equirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not violated if . . . .” What this appears to state in effect is that requires requirements (2) and (3) of the filters of economic effect are treated as satisfied (presumably for all time and for all transactions) if everything else in the paragraph is satisfied. That is unlikely to be what the qualification means. The qualification will not likely be interpreted in that manner. Retiring one partner under an arm’s length agreement meeting the requirements of the qualification does not correct past or future departures from requirements (2) and (3) of the filters of economic effect. The qualification should mean that the retirement of a specific partner under an arms length agreement that satisfies the requirements of the qualification will not be treated as violating requirements (2) and (3) of the filters of economic effect.


Treasury Regulations state that the capital account liquidation requirement is relaxed under these circumstances:

- All or part of the partnership interest of one or more partners is purchased (other than in connection with the liquidation of the partnership)
- By the partnership or by one or more partners (or one or more persons related1026 to a partner)
- Under an agreement negotiated at arm’s length
- By persons who (at the time the agreement is entered into) have materially adverse interests and
- If a principal purpose of the purchase and sale is not to avoid the principles of the second sentence of Treasury Regulations 1.704-1(b)(2)(ii)(a).1027

This creates an exception that permits departures from the capital account liquidation requirement. The qualification applies regardless of whether the pur-

---

1026 Within the meaning of I.R.C. § 267(b) (without modification by I.R.C. § 267(e)(1)) or I.R.C. § 707(b)(1).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

chase is by one or more partners or by one or more of their affiliates. This parallels the scope of those who otherwise might be subject to the qualifications requiring liquidation in accordance with capital accounts.

Your partnership agreement, according to Treasury Regulations, must be negotiated at arm’s length. Whether this means that the partnership must show that there were specific negotiations among the partners concerning the buy-out is unclear. What the partnership should do to establish these negotiations is not clear. (*Query*: should the partnership preserve document drafts, term sheets, etc.? Perhaps a tape of acrimonious negotiations would be useful in establishing arm’s-length negotiations.) Whether the terms of the qualification are satisfied if the partnership cannot establish active negotiations over your partnership agreement is not clear.

When this agreement must be negotiated and entered is not clear from the language of the qualification. The qualification clearly addresses agreements negotiated at the time of the liquidation of the partner under your partnership agreement. Whether the qualification blesses agreements that might be included in your partnership agreement at inception or under a subsequent amendment (but not at the time of the retirement of the partner), is unclear.

Your partnership agreement must be negotiated by persons who (at the time your partnership agreement is entered into) have materially adverse interests. You might presume that this means that the interests are materially adverse as to the economic terms of your partnership agreement (at the time when your partnership agreement terms are negotiated). This suggests that agreements made between related parties will be suspect. Related parties often do not act at arm’s length with respect to one another. (Experience shows that some related parties are exceedingly adverse.) Even when parties are not related, the requirements of the qualification apparently are not met if the interests of the parties are not materially adverse concerning the economics of the retirement agreement.

Your partnership agreement will not satisfy the requirements of the qualification unless “a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of [Treasury Regulations on partnership allocations].” (*Query*: should this be read as “such purchase and sale does not have as a principal purpose the avoidance of the principles of the second sentence of paragraph (b)(2)(ii)(a) of [Treasury Regulations on partnership allocations]”? That is not quite what the qualification states. You may need to interpret the qualification in this manner in order for the qualification to make sense.)

Treasury Regulations reference in the filter refers to the fundamental rule of economic effect:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

(a) Fundamental principles. In order for an allocation to have economic effect, it must be consistent with the underlying economic arrangement of the partners. This means that in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.\textsuperscript{1028}

The qualification, if interpreted literally, requires that a principal purpose of the purchase and sale is not to avoid the principal that “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.” This suggests that the partners must have entered your partnership agreement with a principal purpose that your partnership agreement ensure that “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.” This is a cryptic (one might take it as an absurd) exception – one that does not seem to be especially broad. The qualification is sufficiently cryptic that we cannot be confident that the partnership agreement has satisfied the qualification.

Interpreted more reasonably (but not so literally), the qualification could be interpreted to mean that the purchase and sale does not have as one of its principal purposes undermining the principle that “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.” You might go farther in interpreting the clause and conclude more specifically that the considerations payable in “the purchase and sale [as opposed to the purchase and sale itself] does not have as one of its principal purposes undermining the principle that “in the event there is an economic benefit or economic burden that corresponds to an allocation, the partner to whom the allocation is made must receive such economic benefit or bear such economic burden.”

A further extension of this line of interpretation (even less literal) might propose that the consideration payable in the purchase and sale not be designed to make a gimmick of the allocations – not designed to undermine the integrity of the allocations. Paying any amount other than the partner’s capital account in liquidation of the interest of the retiring partner (or perhaps the partner’s capital account as if it were adjusted by a revaluation of partnership assets) tends to undermine the effect of the allocations in the partnership agreement. The arbitrage between the formula price and the amount that the retiring partner would have received if redeemed for the amount of his capital account (or perhaps the partner’s

\textsuperscript{1028} Treas. Reg. § 1.704-1(b)(2)(ii)(a).
capital account as if it were adjusted by a revaluation of partnership assets) has the effect of undermining (at least in part) the effect of partnership allocations. Only a small extension of the argument is needed to assert that undermining the effect of the partnership allocations was a principal purpose of the terms of the purchase and sale. The resolution of this matter is uncertain.

The qualification might apply to a provision in the partnership agreement providing for a buy-out of a partner upon certain conditions at a formula price—other than buying out the partner at the amount of the partner’s capital account or the fair market value of his partnership interest. The partners, however, might be hard pressed to establish that “a principal purpose of such purchase and sale is not to avoid the principles of the second sentence of paragraph (b)(2)(ii)(a) of [Treasury Regulations on partnership allocations].” The formula price might well have the effect of diminishing the effect of the allocations in the partnership agreement. This might show the prohibited principal purpose. This matter, of course, is debatable.

The qualification might apply to redemption of a partner by the partnership for an amount equal to the agreed fair market value of his partnership interest—the amount of what the partner’s capital account would be if the partnership “booked”-up its assets on the occasion of the redemption. The IRS might argue that this redemption shows the prohibited purpose. The partner is not being retired in accordance with the partner’s capital account. The capital account is presumed best to demonstrate partnership economics.

The qualification might not be satisfied by a partnership agreement that contains a superdilution clause, when capital is shifted among partners on account of one partner’s default in a capital contribution and the dilution clause actually shifts the capital account of the defaulting partners to other partners who make that capital contribution.

You can speculate abundantly about how the qualification from liquidating by capital accounts should be applied in a wide variety of circumstances. Most of us do not understand how the qualification will be applied by the IRS and by the courts. The law will not be clarified until there is a more robust record of litigations concerning the interpretation of this exception.

The partnership agreement does not have to distribute proceeds of liquidation in accordance with capital accounts under certain events, but those events are not particularly clear from Treasury Regulations. Any agreement that requires liquidation of a partner (or the partnership) other than in accordance with capital accounts, is suspect. Be particularly careful about any agreement that mandates the buy-out of a partner at an amount other than the amount in his capital account—and particularly a buy-out of a partner at an amount other than the partner’s share of the net fair market value of partnership assets.
YOU have choice between –

• Distributing proceeds of liquidation of partnership assets in accordance with capital account balances at the end of your partnership’s life and

• Distributing the proceeds in accordance with percentages (perhaps percentages in defined tiers).

Treasury Regulations concerning partnership allocations favor liquidation in accordance with capital accounts. Experience has shown that many draftsmen’s income and loss allocations are careless. Capital accounts sometimes can depart materially from the intended deal, a result that is highly inconvenient when liquidation proceeds are distributed in accordance with partners’ final capital accounts.

There is no unique resolution of the question whether to distribute liquidation proceeds in accordance with capital accounts or to distribute liquidation proceeds by specified tiers. Consider distributing liquidation proceeds by specified tier (rather than by capital accounts) if you are inexperienced. This avoids the possibility of having capital accounts inadvertently at variance from the economic deal and then having to liquidate by capital accounts. A complex economic deal (for example, a deal involving tiers of distributions controlled by satisfying internal rates of return) may be drafted more confidently with liquidation by specified tiers than with liquidation by capital accounts. Partners may require liquidation by capital account if these partners require allocations that meet the technical standard of substantial economic effect. Competent draftsmen should be able confidently to draft most partnership agreements that distribute the proceeds of liquidation by capital account. More experienced draftsmen may be inclined to distribute liquidation proceeds by capital account, except perhaps in the case of complicated economic deals. Distribution by capital accounts is important for allocations to qualify as “qualified allocations” or when allocations are designed to satisfy the nonrecourse deduction safe harbor.

A drafting rage insists that all partnership agreements should distribute cash in liquidation by specified tiers and not by capital accounts under theory that “cash is king.” This style of drafting distribution provisions can bring clients peace of mind that they understand the economic deal, rather than the more difficult liquidation by capital accounts. Badly drafted partnership agreements liqui-

1030 See discussion in text accompanying note 1195.
1031 See discussion in text accompanying note 609.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

dating by specified tiers may result in unexpected taxable income allocations to partners.

Whether to liquidate by capital accounts or by specified tiers requires a professional judgment for the experienced draftsman. There is no single best solution that works for all partnership agreements.

Provide for distribution of the proceeds of liquidation by capital accounts only if you are confident that allocations will result in capital accounts consistent with the economic deal. Regardless of your proficiency, run numerical examples to test that allocation provisions will produce capital accounts consistent with the economic deal. Work closely with your partnership’s accountants to test allocations.\(^\text{1032}\)

You may determine that your partnership should liquidate in accordance with defined percentages or tiers of percentages. This approach may make it more difficult to determine how taxable income and losses shall be allocated annually. Liquidating by defined percentages or tiers of percentages usually (but not invariably) produces a more reliable economic result than liquidation by capital account, especially in the hands of an inexperienced draftsman.

Special tax rules make it difficult for pension plans to invest in partnerships that do not liquidate in accordance with capital accounts (or that have allocations that do not constitute “qualifying allocations”).\(^\text{1033}\) Pension plans and certain other investors will require that allocations satisfy the demanding standards of the “fractions rule” of Section 514(c)(9)(E). Satisfaction of the fractions rule often requires liquidation in accordance with partners’ capital accounts.\(^\text{1034}\)

e. Deficit Capital Account Restoration.

The third requirement of economic effect is that the liquidated partner must restore any deficit balance in his capital account “by the end of such taxable year (or, if later, within 90 days after the date of such liquidation), which amount shall, upon liquidation of the partnership, be paid to creditors of the partnership or distributed to other partners in accordance with their positive capital account balances . . . .” Many general partnerships will seek to satisfy the third requirement of economic effect. You may be drafting a partnership agreement that is designed

\(^{1032}\) Accountants often are confronted by allocation provisions that they cannot understand or that produce results inconsistent with the economic deal. Drafting in consultation with the partnership accountants will reduce the likelihood that capital accounts will be inconsistent with the economic deal.

\(^{1033}\) I.R.C. § 514(c)(9)(E).

\(^{1034}\) See discussion in the text at note 1172.
to satisfy this third requirement. Pay particular attention to the time period in Treasury Regulations for satisfying the deficit restoration obligation. Ensure that you incorporate Treasury Regulations’ definition of “liquidation.” Limited partnership agreements often require the general partner to satisfy the deficit restoration requirement. A limited liability company agreement often will not require a member to restore a deficit balance in the member’s capital account.

Section x.x. Deficit Restoration. Notwithstanding any other provision of this Agreement to the contrary, no Limited Partner has any liability to restore any deficit in its Capital Account upon liquidation of a Limited Partner’s Interest or otherwise (whether or not in connection with a liquidation of the Partnership). No allocation to any Limited Partner of any loss, whether attributable to depreciation or otherwise, shall create any asset of or obligation to the Partnership, even if the allocation reduces a Limited Partner’s Capital Account or creates or increases a deficit in the Limited Partner’s Capital Account. No Limited Partner shall be obligated to pay any deficit amount to or for the account of the Partnership or any creditor of the Partnership. The General Partner is obligated to restore any deficit in its Capital Account, as determined after taking into account all Capital Account adjustments for the Partnership Taxable Year during which the liquidation occurs (in accordance with Treasury Regulations Section 1.704-1(b)(2)(ii)(b)(3)). The General Partner is unconditionally obligated to restore the amount of this deficit balance to the Partnership by the end of this Taxable Year (or, if later, within 90 days after the date of this liquidation). This amount (upon liquidation of the Partnership) shall be paid to creditors of the Partnership or distributed to other Partners in accordance with their positive capital account balances (in accordance with requirement (2) of Treasury Regulations Section (b)(2)(ii)(b)). For this purpose, the liquidation of a Partner’s interest in the Partnership occurs as described in Treasury Regulations Section 1.704-1(b)(2)(ii)(g). Subject to the foregoing, the liquidation of a Partner’s interest in the Partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the Partnership, or (2) the date upon which there is a liquidation of the Partner’s interest in the Partnership under paragraph (d) of Treasury Regulations Section 1.761-1. For purposes of this Section x.x, the liquidation of the Partnership occurs upon the earlier of (1) the date upon which the Partnership is terminated under section 708(b)(1), or (2) the date upon which the Partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its Partners).

Or
**SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS**

Section x.x. No Liability for Negative Capital Accounts. Notwithstanding anything to the contrary in this Agreement, except as otherwise expressly set forth in this Agreement, no Partner nor the Managers has any obligation to make any contribution to the capital of the Partnership, and the negative balance of that Partner’s Capital Account shall not be considered a debt owed by that Partner or the Managers to the Partnership or to any other person for any purpose whatsoever, whether upon a liquidation of his interest in the Partnership (within the meaning of Section 1.704-1(b)(2)(ii)(g) of the Treasury Regulations) or otherwise.

Or

Section x.x. Liability for Negative Capital Accounts. Notwithstanding anything to the contrary in this Agreement, upon a liquidation of his interest in the Partnership (within the meaning of Section 1.704-1(b)(2)(ii)(g) of the Treasury Regulations), any Partner shall be required to fund any deficit balance in his Capital Account in accordance with the rules of Section 1.704-1(b)(2)(ii)(b)(3) of the Treasury Regulations.

Funding deficit capital accounts addresses the third requirement of economic effect. Clearly address whether a partner has liability for the partner’s negative capital account. The partner may have liability. Clearly state when the partner is required to discharge this liability. A general partner often will have liability to fund his negative capital account upon a liquidation of his interest in the partnership. A member of a limited liability company or a limited partner of a limited partnership normally will not have liability to fund his negative capital account on the liquidation of his interest in the partnership.

Some draftsmen seek to limit the liability of a partner with a deficit restoration obligation by providing that the deficit restoration obligation can be enforced by the partnership but not by a third-party creditor. There is no controlling authority concerning whether this deficit restoration obligation will work satisfactorily for tax purposes. It is not clear how such a deficit restoration obligation will work for corporate law purposes.

The Tax Court in *Hubert Enterprises v. Commissioner* held that a deficit restoration obligation in the operating agreement of a limited liability company

---

1035 125 T.C. No. 6 (September 21, 2005). See Susan Kalinka, “*Hubert Enterprises: LLC Members, Partners, Deficit Restoration Obligations, and the At-Risk Rules,*” 112 TAX NOTES 137 (July 10, 2006); Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, “*The Effect of a ‘DRO’ on a Partner’s At-Risk Amount and Share of Liabilities: Hubert Enterprises v. Commissioner,*” 111 TAX NOTES 1031 (May 29, 2006); Blake D. Rubin, Andrea Macintosh Whiteway & (footnote continued on the next page)
engaged in an equipment leasing business did not increase at-risk amounts under Section 465. The theory of *Hubert Enterprises* was that the obligation was not effective until the liquidation of the members’ interests in the limited liability company were liquidated. At the time when this Article is written, *Hubert Enterprises* is on appeal.

A court hearing a tax dispute might determine that a deficit restoration obligation that does not permit a creditor to enforce the obligation does not transfer the economic risk of loss of the deficit capital account to the partner with the deficit capital account. Alternatively, the court might determine that the deficit restoration obligation is without economic substance.

A bankruptcy court, in contrast, might permit the trustee of the partnership estate in bankruptcy to enforce a deficit restoration clause against a partner, even though the partnership agreement states that the clause cannot be enforced by a third-party creditor.

f. Other Conventions.

The filter of economic effect is larded with a series of other conventions.

The partnership taxable year is determined without regard to section 706(c)(2)(A).\(^{1036}\) This provision states that the partnership taxable year closes with respect to a partner whose entire interest terminates.\(^{1037}\) Disregard the closing of the taxable year on the sale of a partnership interest that does not terminate the partnership itself in applying the rules of economic effect. The requirement of distributing redemption proceeds to a partner in accordance with his capital account is waived if the interest is redeemed “pursuant to an agreement negotiated at arm’s length by persons who at the time such agreement is entered into have materially adverse interests.”\(^{1038}\) The precise application of this relaxation of the capital account liquidation requirement is unresolved, as discussed above. Capital

---

Jon G. Finkelstein, *“Hubert Enterprises, Inc.: Does a Capital Account Deficit Restoration Increase a Partner’s At-Risk Amount or Share of Liabilities?”* 9 Passthrough Entities 7 (March/April 2006).

\(^{1036}\) I.R.C. § 706(c)(2)(A)(2) (“The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise).”)

\(^{1037}\) I.R.C. § 706(c)(2)(A) (“(2) Treatment of dispositions. (A) Disposition of entire interest. The taxable year of a partnership shall close with respect to a partner whose entire interest in the partnership terminates (whether by reason of death, liquidation, or otherwise).”)

\(^{1038}\) Treas. Reg. § 1.704-1(b)(2)(ii)(b). This rule is discussed above in some detail in text at note 1025.
accounts can be revalued on stated events.\textsuperscript{1039} This provision permits revaluation on liquidation of a partner.

g. **Alternate Test for Economic Effect.**

Limited partnerships and limited liability companies often take advantage of an alternate test for economic effect. This alternate test for economic effect provides relief from the requirement that a partner with a deficit capital account fund that deficit capital account. Allocations are treated as having economic effect (at least over a limited domain) if they satisfy the alternate test for economic effect.\textsuperscript{1040}

The alternate test for economic effect is the partnership agreement drafting analogue to string theory. The alternate test for economic effect is a test of exquisite complexity and uncertainty that is unlikely often to be applied rigorously by partnership accountants – or understood by many students of partnership taxation – or even their professors. Navigating the alternate test for economic effect is much like navigating the Minotaur’s cave. One is inclined to wonder whether the alternate test for economic effect was not written by some incredible tax genius – some sort of tax \textit{Übermensch}, – and only he understands and can apply the rules.\textsuperscript{1041} Even a short overview of the alternate test for economic effect suggests the need for some sort of tax \textit{Übermensch} to understand the rules competitently. Whether anyone fully understands the alternate test for economic effect is uncertain.\textsuperscript{1042} There is some lingering doubt whether the alternate test for economic effect can be fully comprehended.

\footnotesize
\textsuperscript{1039} Treas. Reg. § 1.704-1(b)(2)(ii)(b). See discussion in text at note 816.
\textsuperscript{1040} Treas. Reg. § 1.704-1(b)(2)(ii)(d).
\textsuperscript{1041} See, generally, Friedrich Nietzsche, \textit{Also Sprach Zarathustra}.
\textsuperscript{1042} Treas. Reg. § 1.704-1(b)(2)(ii)(d). This is the formal statement of the alternate test for economic effect:

\(d\) **Alternate test for economic effect. If--**

\(1\) Requirements (1) and (2) of paragraph \((b)(2)(ii)(b)\) of this section are satisfied, and

\(2\) The partner to whom an allocation is made is not obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph \((b)(2)(ii)(b)\) of this section), or is obligated to restore only a limited dollar amount of such deficit balance, and

\(3\) The partnership agreement contains a “qualified income offset,” such allocation will be considered to have economic effect under this paragraph \((b)(2)(ii)(d)\) to the extent such allocation does not cause or in-

(footnote continued on the next page)
create a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates. In determining the extent to which the previous sentence is satisfied, such partner’s capital account also shall be reduced for—

(4) Adjustments that, as of the end of such year, reasonably are expected to be made to such partner’s capital account under paragraph (b)(2)(iv)(k) of this section for depletion allowances with respect to oil and gas properties of the partnership, and

(5) Allocations of loss and deduction that, as of the end of such year, reasonably are expected to be made to such partner pursuant to section 704(e)(2), section 706(d), and paragraph (b)(2)(ii) of section 751-1, and

(6) Distributions that, as of the end of such year, reasonably are expected to be made to such partner to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made “(other than increases pursuant to a minimum gain chargeback under paragraph (b)(4)(iv)(e) of this section or under section 1.704-2(f); however, increases to a partner’s capital account pursuant to a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain)” under section 1.704-2(f).

For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply. The partnership agreement contains a “qualified income offset” if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners’ interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied. . . .

The alternate test for economic effect relaxes the deficit restoration requirement of the basic test for economic effect. This makes the alternate test for economic effect attractive to liability limiting entities (for example, limited partnerships and limited liability companies). A partnership agreement taking advantage of the alternate test for economic effect is drafted in substantially the same manner as a partnership agreement taking advantage of the basic test of economic effect, except that the partnership agreement taking advantage of the alternate test for economic effect does not provide for capital account deficit restoration and it will limit loss allocations to partners who are not obligated to restore their deficit capital accounts. The partnership agreement often contains a limitation that prevents loss allocations to a partner beyond the amount permitted under the alternate test for economic effect.

The alternate test for economic effect permits loss allocations (recourse loss allocations) to partners through the region over which partners bear the economic burden of the recourse losses either as charges that reduce their positive capital accounts (reducing the amount that the partners will receive in liquidations) or through actual or deemed deficit restoration obligations. A partner’s share of minimum gain or of partner nonrecourse debt minimum gain is treated as a deficit restoration obligation for this purpose. This deemed deficit restoration obligation has the same effect as items increasing capital accounts (giving the partner extra capacity to deduct recourse losses). (Minimum gain and partner nonrecourse debt minimum gain do not literally increase capital accounts for this purpose. Instead, minimum gain and partner nonrecourse debt minimum gain are treated as deficit restoration obligations. A partner’s capacity to absorb recourse losses includes both the partner’s positive capital account and his deficit restoration obligation. Treating shares of minimum gain and partner nonrecourse debt minimum gain as deficit restoration obligations increases the partner’s capacity to absorb recourse losses.)

The alternate test for economic effect does not affect loss allocations of nonrecourse deductions and partner nonrecourse deductions. These deductions follow their own rules outside of the rules of substantial economic effect.\footnote{1043}{See, generally, Treas. Reg. § 1.704-2.} \footnote{1044}{Treas. Reg. § 1.704-1(b)(2)(ii)(d).} More technically, “such allocation will be considered to have economic effect under this paragraph (b)(2)(ii)(d) to the extent such allocation does not cause or increase a deficit balance in such partner’s capital account (in excess of any limited dollar amount of such deficit balance that such partner is obligated to restore) as of the end of the partnership taxable year to which such allocation relates.”\footnote{1043}{See, generally, Treas. Reg. § 1.704-2.}
partner’s positive capital account (as specially adjusted). After loss allocations reduce the partner’s capital account to zero, the loss allocations to the partner are permitted until the partner’s capital account has a deficit balance equal to the limited amount that the partner is required to restore (or is treated as obligated to restore on account of minimum gain or alternative minimum gain).  

---

1045 This restoration requirement is further expanded in Treasury Regulations:

(c) Obligation to restore deficit. If a partner is not expressly obligated to restore the deficit balance in his capital account, such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent of—

(1) The outstanding principal balance of any promissory note (of which such partner is the maker) contributed to the partnership by such partner (other than a promissory note that is readily tradable on an established securities market), and

(2) The amount of any unconditional obligation of such partner (whether imposed by the partnership agreement or by State or local law) to make subsequent contributions to the partnership (other than pursuant to a promissory note of which such partner is the maker), provided that such note or obligation is required to be satisfied at a time no later than the end of the partnership taxable year in which such partner’s interest is liquidated (or, if later, within 90 days after the date of such liquidation). If a promissory note referred to in the previous sentence is negotiable, a partner will be considered required to satisfy such note within the time period specified in such sentence if the partnership agreement provides that, in lieu of actual satisfaction, the partnership will retain such note and such partner will contribute to the partnership the excess, if any, of the outstanding principal balance of such note over its fair market value at the time of liquidation. . . . A partner in no event will be considered obligated to restore the deficit balance in his capital account to the partnership (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section) to the extent such partner’s obligation is not legally enforceable, or the facts and circumstances otherwise indicate a plan to avoid or circumvent such obligation. . . . For purposes of this paragraph (b)(2), if a partner contributes a promissory note to the partnership during a partnership taxable year beginning after December 29, 1988 and the maker of such note is a person related to such partner (within the meaning of section 1.752-1T(h), but without regard to subdivision (4) of that section), then such promissory note shall be treated as a promissory note of which such partner is the maker.

(footnote continued on the next page)
The lead-in language and its parenthetical are ambiguous. Some advisors are concerned that the language “such partner nevertheless will be treated as obligated to restore the deficit balance in his capital account (in accordance with requirement (3) of paragraph (b)(2)(ii)(b) of this section)” suggests that a partner with a limited deficit restoration obligation may be treated as satisfying the principal test of economic effect. This language may suggest that the third requirement of economic effect is treated as satisfied. This conclusion is not supported by the scheme of Treasury Regulations. A limited deficit restoration obligation can help the partnership to satisfy the alternate test for economic effect. A limited deficit restoration obligation will not permit the partnership to satisfy the principal test of economic effect.

Limited deficit capital account restoration obligations generally are respected only to the extent that the obligations are an unconditional obligation of the partner (whether imposed by the partnership agreement or by State or local law). Furthermore, the obligation must be “required to be satisfied at a time no


“Liquidation” in this context is nuanced:

_a liquidation of a partner’s interest in the partnership occurs upon the earlier of (1) the date upon which there is a liquidation of the partnership, or (2) the date upon which there is a liquidation of the partner’s interest in the partnership under paragraph (d) of section 1.761-1. For purposes of this paragraph, the liquidation of a partnership occurs upon the earlier of (3) the date upon which the partnership is terminated under section 708(b)(1), or (4) the date upon which the partnership ceases to be a going concern (even though it may continue in existence for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its partners). Requirements (2) and (3) of paragraph (b)(2)(ii)(b) of this section will be considered unsatisfied if the liquidation of a partner’s interest in the partnership is delayed after its primary business activities have been terminated (for example, by continuing to engage in a relatively minor amount of business activity, if such actions themselves do not cause the partnership to terminate pursuant to section 708(b)(1)) for a principal purpose of deferring any distribution pursuant to requirement (2) of paragraph (b)(2)(ii)(b) of this section or deferring any partner’s obligations under requirement (3) of paragraph (b)(2)(ii)(b) of this section._

later than the end of the partnership taxable year in which such partner’s interest is liquidated (or, if later, within 90 days after the date of such liquidation).”

The alternate test of economic effect does not provide adequately for exculpatory deductions. No partner bears the economic risk of loss of exculpatory deductions. A partner’s share of exculpatory deductions apparently is not treated as a deemed deficit restoration obligation.

h. Limitations on Loss Allocations.

Partnership agreements frequently will contain limitations in response to the alternate test for economic effect. This is an example of such a limitation:

Section x.x. Limitation on Allocation of Net Losses. Net Losses shall not be allocated to any Partner to the extent that an allocation of Net Losses to the Partner creates or increases (as a negative amount) an Adjusted Capital Account Deficit. Any Net Losses not allocated to a Partner on account of the operation of this Section x.x shall be reallocated to the other Partners (who do not have Adjusted Capital Account Deficits) in accordance with the priorities set forth in Section y.y.

This is a similar provision:

Section x.x Net Losses Limitation. No Partner shall be allocated Net Losses or deductions if the allocation causes the Partner to have an Adjusted Capital Account Deficit. Any allocation of Net Losses or deduction that cannot be made to a Partner by reason of this Section x.x shall be made to Partners (who have positive Adjusted Capital Account balances) in accordance with their relative Adjusted Capital Account balances. To the extent that any Partners are allocated an amount of Net Losses or deduction by reason of the previous sentence, items of income or gain shall be allocated to these Partners (in subsequent Fiscal Years) as soon as possible to reverse prior allocations of Net Losses.

The “Adjusted Capital Account Deficit” relates to the alternative test of economic effect. The “Adjusted Capital Account Deficit” is the negative amount (if any) determined by starting with the Partner’s capital account as of the end of the relevant Partnership Year and adjusting the Partner’s capital account in accordance with these rules:

---

1047 See discussion of exculpatory deductions in text at notes 36 and 370.
1048 See discussion in text accompanying note 1040.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Increasing the partner’s capital account by any amounts that the
  partner is obligated to restore upon liquidation of the partner’s
  partnership interest or is deemed to be obligated to restore under
  the penultimate sentence of each of Treasury Regulations Sections
  1.704-2(g)(1) and 1.704-2(i)(5); and

- Decreasing the partner’s capital account by the items described in
  Treasury Regulations Section 1.704-1(b)(2)(ii)(d)(4), (5) and (6).

i. Capital Account Maintenance and Liquidation.

The first two requirements of the alternate test for economic effect are that
requirements (1) and (2) of Treasury Regulations Section 1.704-1(b)(2)(ii)(b)
be satisfied. These requirements require satisfaction of the capital account
maintenance requirement of economic effect and the capital account liquidation
requirement of economic effect. A partner must receive the amount in his capital
account upon liquidation of his interest in the partnership or upon the liquidation
of the partnership. This requires defining “liquidation” as defined in Treasury
Regulations.\textsuperscript{1049}

\textsuperscript{1049} Treas. Reg. § 1.704-1(b)(2)(iv)(g). These requirements are subject to
these limitations:

Requirements (2) and (3) of this paragraph (b)(2)(ii)(b) are not viol-
ated if all or part of the partnership interest of one or more partners is
purchased (other than in connection with the liquidation of the part-
nership) by the partnership or by one or more partners (or one or more
persons related, within the meaning of section 267(b) (without modification
by section 267(e)(1)) or section 707(b)(1), to a partner) pursuant to an
agreement negotiated at arm’s length by persons who at the time such
agreement is entered into have materially adverse interests and if a pri-
ncipal purpose of such purchase and sale is not to avoid the principles of
the second sentence of paragraph (b)(2)(ii)(a) of this section. In addition,
requirement (2) of this paragraph (b)(2)(ii)(b) is not violated if, upon the
liquidation of the partnership, the capital accounts of the partners are
increased or decreased pursuant to paragraph (b)(2)(iv)(f) of this sec-
tion as of the date of such liquidation and the partnership makes liquidat-
ing distributions within the time set out in that requirement (2) in the rati-
os of the partners’ positive capital accounts, except that it does not dis-
tribute reserves reasonably required to provide for liabilities (contingent
or otherwise) of the partnership and installment obligations owed to the
partnership, so long as such withheld amounts are distributed as soon as
(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

j. Adjustments to Capital Account.

Capital accounts are adjusted for purposes of the alternate test for economic effect by making the downward adjustments set forth in subparagraphs (4), (5), and (6). These adjustments incidentally are incorporated in the definition of “Adjusted Capital Accounts,” which is a feature of many partnership agreements. The subparagraph (4), (5), and (6) adjustments are the beginning of the mysteries of the alternate test for economic effect. The subparagraph (4), (5), and (6) adjustment are both complicated and in some respects uncertain.

The generic purpose of the subparagraph (4), (5), and (6) adjustments is to reduce capital accounts (and the partner’s capacity to be allocated recourse losses) by reasonably anticipated items that will lower capital accounts outside of the regime governing partnership allocations (Section 704(b)). The subparagraph (4), (5), and (6) adjustments to capital account under the alternate test for economic effect apparently are intended to be a comprehensive list of downward adjustments to capital account that operate outside of the regime governing partnership allocations (Section 704(b)).

Taxpayers and their advisors need precise, hard numbers concerning the various subparagraph (4), (5), and (6) adjustments to capital accounts in order to be able to apply the alternate test for economic effect. Approximate guesses do not work well. Tax returns require precise and not approximate numbers. The nature of the subparagraph (4), (5), and (6) adjustments, however, does not lend them to the precision required to apply the alternate test for economic effect rigorously.

i) Depletion.

The adjustment in subparagraph (4) is limited to reasonably expected depletion allowances. As the adjustment is intended, the downward adjustment described in subparagraph (4) is equal to the maximum downward adjustment to capital account that could reasonably be expected. Treasury Regulations do not provide guidance concerning what considerations go into determining the subparagraph (4) downward adjustment. These subparagraph (4) adjustments do not affect most real estate partnership agreements. This adjustment relates to Section 613A(c)(7)(D) and the oil and gas depletion rules.

Oil and gas depletion is treated as deductible at the partner level rather than at the partnership level. Depletion is computed separately by the partners

practicable and in the ratios of the partners’ positive capital account balances.

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(and not the partnership). Separate partner computation permits the individual partner to determine whether he qualifies for percentage depletion.\textsuperscript{1050} The partnership allocates to each of its partners a proportionate share of the partnership’s adjusted tax basis in each oil or gas property. The partner makes his own determination of whether to use cost or percentage depletion at the partner level. Each partner’s proportionate share of the partnership’s adjusted tax basis in each oil or gas property is generally determined in accordance with the partner’s proportionate interest in partnership capital (at the time of the allocation). Under an exception, each partner’s proportionate share of the partnership’s adjusted tax basis in each oil or gas property is determined in accordance with his proportionate interest in partnership income if both –

- The partnership agreement provides that a partner’s share of the adjusted tax basis of one or more properties is determined in accordance with his proportionate interest in partnership income;\textsuperscript{1051} and

- At the time of allocation under the partnership agreement, the share of each partner in partnership income is reasonably expected to be substantially unchanged throughout the life of the partnership.\textsuperscript{1052}

The partners’ shares of adjusted tax basis are determined on a property-by-property basis. The basis of one property may be allocated in proportion to capital and the basis of another property may be allocated in proportion to income.

Depletion deductions are not subject to the rules governing partnership allocations (Section 704(b)). The purpose of the adjustment in subparagraph (4) is to reduce a partner’s capital account by reasonably expected future depletion de-

\textsuperscript{1050} Treas. Reg. § 1.613A-3(e)(1) (“In the case of a partnership, the depletion allowance under section 611 with respect to production from domestic oil and gas properties shall be computed separately by the partners and not by the partnership. The determination of whether cost or percentage depletion is applicable is to be made at the partner level. The partnership must allocate to each partner the partner’s proportionate share of the adjusted basis of each partnership oil or gas property in accordance with the provisions of paragraphs (e)(2) through (e)(6) of this section. This allocation of the adjusted basis of oil or gas property does not affect a partner’s adjusted basis in his partnership interest.”).

\textsuperscript{1051} Treas. Reg. § 1.613A-3(e)(2)(ii)(A).

\textsuperscript{1052} Other than changes merely to reflect the admission of a new partner, an increase in a partner’s interest in consideration for money, property, or services, or a partial or complete withdrawal of an existing partner. Treas. Reg. § 1.613A-3(e)(2)(ii)(B).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ductions. These depletion deductions are not otherwise limited by the regime governing partnership allocations (Section 704(b)). This adjustment sensibly reduces capital accounts for the future depletion deductions in order to determine capacity to deduct other items. Otherwise, future depletion deductions might drive a partner’s capital account negative beyond any actual or deemed deficit restoration obligation. Although allocations of depletion are not subject to the loss limitation rules of the alternate test for economic effect, but allocations of depletion will reduce capital account.

ii) Section 704(e)(2), Section 706(d), and Section 751.

The adjustment in subparagraph (5) decreases capital accounts on account of allocations of loss and deduction that, as of the end of the partnership’s taxable year, reasonably are expected to be made to the partner under Section 704(e)(2), Section 706(d), and paragraph (b)(2)(ii) of Section 751-1. These are obscure adjustments. The idea is that these adjustments reflect future loss items that can be deducted by a partner in a future year outside of the regime governing partnership allocations (Section 704(b)). Few advisors apply these adjustments in practice. The downward adjustment under subparagraph (5) should be the maximum future downward adjustment that could reasonably be anticipated under Section 704(e)(2), Section 706(d), and paragraph (b)(2)(ii) of Section 751-1. Treasury Regulations provide no guidance on how advisors or taxpayers are supposed to determine this maximum future downward adjustment.

iii) Section 704(e)(2) Adjustments.

Section 704(e) provides rules under which a person is treated as a bona fide partner for federal income tax purposes “if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.”

---

1053 Section 704(e)(2) provides:

(2) Distributive share of donee includible in gross income. In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor’s capital. The distributive share of a part-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

This provision should be important principally to draftsmen who are operating within the context of partnerships affected by the family partnership rules. Income can be reallocated under certain circumstances in the case of a partnership interest created by gift – when the partnership has not paid reasonable compensation for services rendered to the partnership by the donor, and when allocations are not proportionate to the donor’s capital. The rules of Section 704(e) suggest special caution in the context of drafting partnership agreements including more than one member of a family.

The basic rule respects the donee of a partnership interest as a partner, if capital is a material income-producing factor. This test refers to all the facts of each case. “Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. Capital, in general, is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.”

The rule generally respects allocations to the donee partner if three requirements are met:

- First, the allocations would be respected in the absence of the gift (for example, the allocations have substantial economic effect).
- Second, reasonable compensation is provided for services rendered to the partnership by the donor.
- Third, the portion of the donee’s distributive share attributable to donated capital is not proportionately greater than the distributive share attributable to the donor’s capital.

A “capital interest” in a partnership purchased by one member of a family from another is considered to be created by gift from the seller. The fair market value of the purchased interest is considered to be donated capital. The “family” of any individual, for this purpose, includes only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of these persons.

\footnote{\textit{ner in the earnings of the partnership shall not be diminished because of absence due to military service.}}

\textsuperscript{1054} Treas. Reg. § 1.704-1(e)(1)(iv).

\textsuperscript{1055} Treas. Reg. § 1.704-1(e)(3)(i)(a).
Special rules apply when the partnership agreement does not follow the three special requirements immediately set forth above. To the extent that the partnership agreement does not allocate the partnership income in accordance with these rules, the distributive shares of the partnership income of the donor and donee are supposed to be reallocated by making a reasonable allowance for the services of the donor and by attributing the balance of the income to the partnership capital of the donor and donee. The portion of income (if any) attributable to partnership capital for the taxable year is allocated between the donor and donee in accordance with their respective interests in partnership capital.

The reasonable allowance for services rendered by the partners considers all of the facts and circumstances of the business (including the fact that some of the partners may have greater managerial responsibility than others). This reasonable allowance for services rendered by the partners considers the amount that would ordinarily be paid in order to obtain comparable services from a person not having an interest in the partnership. The market often establishes a range of compensation available for services. The family partnership rules suggest guidelines for establishing the amount allowed for services, but they do not determine a precise number. This makes the subparagraph (5) adjustment to capital account in applying the alternate test for economic effect subjective.

A special rule applies to a partner serving in the Armed Forces of the United States. The distributive share of partnership income of a partner who rendered services to the partnership before entering the Armed Forces of the United States is not to be diminished because of absence due to military service. This distributive share shall be adjusted to reflect increases or decreases in the capital interest of the absent partner. The partners may by agreement allocate a smaller share to the absent partner serving in the Armed Forces of the United States due to his absence. The Armed Forces rules provides long-term amnesty and is not limited to a single term of enlistment or to foreign deployment.

The subparagraph (5) adjustment to capital account in applying the alternate test for economic effect is equal to the decreases to capital accounts on account of allocations of loss and deduction that, as of the end of the partnership’s taxable year, reasonably are expected to be made in future periods to the partner under Section 704(e)(2). The subparagraph (5) adjustment to capital account (for reasonably anticipated Section 704(e)(2) loss or deduction adjustments to capital

---

1057 Other than a reasonable allowance for the services (if any) rendered by the donee.
account) requires projection of future anticipated losses or deductions resulting from imputed compensation. A tax philosopher may be able to understand the need for this adjustment. Loss allocations after a partner has reached the allocation limits (imposed by the alternate test for economic effect) offend the theory of the alternate test for economic effect. Coming up with a specific number for the reasonably anticipated adjustment is an impressive task. The test appears to have been designed more as a theoretical construct rather than a user-friendly tool. The subparagraph (5) adjustment to capital account (on account of allocations of loss and deduction that, as of the end of the partnership’s taxable year, reasonably are expected to be made to the partner under Section 704(e)(2)) in applying the alternate test for economic effect is impractical to apply in practice. Whether the situation is ameliorated by the qualified income offset is unresolved on account of the ambiguity in the language of the qualified income offset.

iv) Section 706 Adjustments.

The second adjustment to capital account under subparagraph (5) is on account of allocations of loss and deduction that reasonably are expected to be made to the partner under section 706(d). This determination is made as of the end of the year. These are future loss items that are allocated irrespective of the regime governing partnership allocations (Section 704(b)). The adjustments under Section 706(d) are discussed in the text accompanying note 645.

You need to scour Section 706(d) in order to look for allocations of items of loss and deduction that reasonably are expected to be made in the future to the partner under Section 706(d) – items that are not subject to Section 704(b) limitations. This determination is made as of the end of the year.

Subparagraph (d)(1) prorates tax items when a change in ownership of a partnership interest occurs during the partnership’s taxable year. This subparagraph should not normally cause an adjustment under subparagraph (5). This subparagraph does not result in post-taxable year adjustments.

Subparagraph (d)(2) prorates cash basis items over the period to which they are attributable. This can create items that, on the last day of the partnership’s taxable year, are reasonably expected to create downward capital account adjustments after the close of the taxable year and that apparently operate outside of the regime governing partnership allocations (Section 704(b)). Applying this capital account adjustment requires careful accounting and particular sensitivity to the alternate test for economic effect. Prepaid cash basis items (for example, interest, taxes, payments for services or for the use of property, etc.) would seem to be candidates for the downward adjustment to capital accounts in applying the alternate test for economic effect. This adjustment makes sense and is computable – if a bit technical for most accountants to apply.
Subparagraph (d)(3) discusses items attributable to an interest in a lower-tier partnership prorated over the entire taxable year. This provision prorates items of the lower-tier partnership to the partners of an upper-tier partnership. This provision can produce a downward adjustment to capital account in applying the alternate test for economic effect — circumstances in which loss items are prorated from an early year to a later year and deductible in the later year without reference to the limitations that apply to partnership allocations (Section 704(b)).

v) Section 751(b) Adjustments.

The last downward adjustment to capital accounts under subparagraph (5) is made on account of allocations of loss and deduction that reasonably are expected to be made to the partner under paragraph (b)(2)(ii) of Treasury Regulations Section 751-1. This determination is made as of the end of the year. These Treasury Regulations interpret the collapsible partnership rules of Section 751. Paragraph (b)(2)(ii) involves distributions that readjust a partner’s ratio of collapsible to noncollapsible property.¹⁰⁶⁰

The IRS has yet to demonstrate how the Section 751(b) Treasury Regulations can create a downward adjustment to capital account for purposes of applying the alternate test for economic effect. Perhaps the downward adjustment contemplates a contemplated Section 751(b) distribution that will create a loss allocable to a partner. Whether the distribution will create a loss allocable to the partner in a future period is unresolved. At the least, the rôle of these Treasury Regu-

¹⁰⁶⁰ Treas. Reg. § 1.704-1(b)(2) (“(b)(2) Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items). (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution). (ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner’s interest in other partnership property that he relinquished in the exchange. In computing the partners’ distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).”).
vi) Distributions over Positive Capital Account Adjustments.

The subparagraph (6) adjustment is important in applying the alternate test for economic effect. This adjustment addresses reasonably anticipated future distributions in excess of corresponding net positive adjustments to capital account. A partner in theory might receive an allocation of recourse losses that drives his capital account to zero. immediately after the end of the partnership’s taxable year, he might receive a distribution that created a negative capital account when the partner did not bear the risk of the negative capital account. This was perceived by the IRS as a potentially abusive situation that might permit a taxpayer to gimmick the rules of the alternate test for economic effect. The subparagraph (6) adjustment is a downward adjustment to the partner’s capital account for –

- Distributions that, as of the end of such year, reasonably are expected to be made to such partner …
- … to the extent they exceed offsetting increases to such partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which such distributions reasonably are expected to be made …
- … other than increases under a minimum gain chargeback; …
- however, increases to a partner’s capital account under a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain under Treasury Regulations Section 1.704-2(f).

Imagine a world of perfect information about the future. Each year you would calculate for each year the excess of (i) distributions to the partner as of the end-of-the-year over (ii) offsetting increases to the partner’s capital account. As a first approximation, the downward adjustment to capital accounts is equal to the maximum projected cumulative excess that may exist over time.

You might imagine a partnership with this projected performance (for a particular partner) for the future:
This table shows the calculation of the future distributions that, as of the end of the partnership’s taxable year, reasonably are expected to be made to the partner to the extent that they exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which the distributions reasonably are expected to be made:
### Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

<table>
<thead>
<tr>
<th>Year</th>
<th>Distribution</th>
<th>Income (Loss)</th>
<th>Offsetting Increases to Capital Account</th>
<th>Distributions over Offsetting Increases to Capital Account</th>
<th>Cumulative Distributions over Offsetting Increases to Capital Account</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>$0</td>
<td>($60,000)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2007</td>
<td>$0</td>
<td>($45,000)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2008</td>
<td>$0</td>
<td>($52,000)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2009</td>
<td>$0</td>
<td>($32,000)</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2010</td>
<td>$16,000</td>
<td>($18,000)</td>
<td>$0</td>
<td>$16,000</td>
<td>$16,000</td>
</tr>
<tr>
<td>2011</td>
<td>$5,000</td>
<td>($21,000)</td>
<td>$0</td>
<td>$5,000</td>
<td>$21,000</td>
</tr>
<tr>
<td>2012</td>
<td>$5,550</td>
<td>($8,000)</td>
<td>$0</td>
<td>$5,550</td>
<td>$26,550</td>
</tr>
<tr>
<td>2013</td>
<td>$6,161</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$4,161</td>
<td>$30,711</td>
</tr>
<tr>
<td>2014</td>
<td>$6,839</td>
<td>$6,000</td>
<td>$6,000</td>
<td>$8,39</td>
<td>$31,550</td>
</tr>
<tr>
<td>2015</td>
<td>$7,591</td>
<td>$6,660</td>
<td>$6,660</td>
<td>$9,31</td>
<td>$32,481</td>
</tr>
<tr>
<td>2016</td>
<td>$8,426</td>
<td>$7,393</td>
<td>$7,393</td>
<td>$10,33</td>
<td>$33,514</td>
</tr>
<tr>
<td>2017</td>
<td>$9,353</td>
<td>$8,206</td>
<td>$8,206</td>
<td>$1,147</td>
<td>$34,661</td>
</tr>
<tr>
<td>2018</td>
<td>$10,382</td>
<td>$9,109</td>
<td>$9,109</td>
<td>$1,273</td>
<td>$35,934</td>
</tr>
<tr>
<td>2019</td>
<td>$11,524</td>
<td>$10,111</td>
<td>$10,111</td>
<td>$1,413</td>
<td>$37,347</td>
</tr>
<tr>
<td>2020</td>
<td>$12,792</td>
<td>$11,223</td>
<td>$11,223</td>
<td>$1,569</td>
<td>$38,916</td>
</tr>
<tr>
<td>2021</td>
<td>$14,199</td>
<td>$12,458</td>
<td>$12,458</td>
<td>$1,741</td>
<td>$40,657</td>
</tr>
<tr>
<td>2022</td>
<td>$15,761</td>
<td>$13,828</td>
<td>$13,828</td>
<td>$1,933</td>
<td>$42,590</td>
</tr>
<tr>
<td>2023</td>
<td>$17,495</td>
<td>$15,349</td>
<td>$15,349</td>
<td>$2,146</td>
<td>$44,736</td>
</tr>
<tr>
<td>2024</td>
<td>$19,419</td>
<td>$17,037</td>
<td>$17,037</td>
<td>$2,382</td>
<td>$47,118</td>
</tr>
<tr>
<td>2025</td>
<td>$21,555</td>
<td>$18,911</td>
<td>$18,911</td>
<td>$2,644</td>
<td>$49,762</td>
</tr>
<tr>
<td>2026</td>
<td>$23,926</td>
<td>$20,991</td>
<td>$20,991</td>
<td>$2,935</td>
<td>$52,697</td>
</tr>
<tr>
<td>2027</td>
<td>$26,558</td>
<td>$23,300</td>
<td>$23,300</td>
<td>$3,258</td>
<td>$55,955</td>
</tr>
<tr>
<td>2028</td>
<td>$29,479</td>
<td>$25,863</td>
<td>$25,863</td>
<td>$3,616</td>
<td>$59,571</td>
</tr>
<tr>
<td>2029</td>
<td>$32,722</td>
<td>$28,708</td>
<td>$28,708</td>
<td>$4,014</td>
<td>$63,585</td>
</tr>
<tr>
<td>2030</td>
<td>$36,321</td>
<td>$31,866</td>
<td>$31,866</td>
<td>$4,455</td>
<td>$68,040</td>
</tr>
<tr>
<td>2031</td>
<td>$40,316</td>
<td>$35,371</td>
<td>$35,371</td>
<td>$4,945</td>
<td>$72,985</td>
</tr>
<tr>
<td>2032</td>
<td>$44,751</td>
<td>$39,262</td>
<td>$39,262</td>
<td>$5,489</td>
<td>$78,474</td>
</tr>
<tr>
<td>2033</td>
<td>$49,674</td>
<td>$43,581</td>
<td>$43,581</td>
<td>$6,093</td>
<td>$84,567</td>
</tr>
<tr>
<td>2034</td>
<td>$55,138</td>
<td>$48,375</td>
<td>$48,375</td>
<td>$6,763</td>
<td>$91,330</td>
</tr>
<tr>
<td>2035</td>
<td>$61,203</td>
<td>$53,696</td>
<td>$53,696</td>
<td>$7,507</td>
<td>$98,837</td>
</tr>
<tr>
<td>2036</td>
<td>$67,935</td>
<td>$59,603</td>
<td>$59,603</td>
<td>$8,332</td>
<td>$107,169</td>
</tr>
<tr>
<td>2037</td>
<td>$75,408</td>
<td>$66,159</td>
<td>$66,159</td>
<td>$9,249</td>
<td>$116,418</td>
</tr>
<tr>
<td>2038</td>
<td>$320,000</td>
<td>$436,418</td>
<td>$436,418</td>
<td>($116,418)</td>
<td>$0</td>
</tr>
</tbody>
</table>

The alternate test for economic effect might be clearer. The downward adjustment to capital account of the partner at the end of year 2006 under subpara-
graph (6) based on these numbers appears to be $116,000. This is the largest entry for cumulative distributions over offsetting increases to capital account. The numbers for 2038 are suspect on account of this presumption under the alternate test for economic effect: “For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply.” How thoroughly this rule (the “value equals basis” rule) will intrude on the computations under the alternate test for economic effect is not clear.

A large refinancing reasonably anticipated in the distant future may have a small present value impact on the partnership, but it may have a dramatic effect on the application of the alternate test for economic effect.

The discussion has assumed a deterministic world of perfect information. The world, of course, is anything but deterministic and information is anything but perfect. The subparagraph (6) adjustment is supposed to be the amount of distributions that, as of the end of the partnership’s taxable year, reasonably are expected to be made to the partner to the extent that they exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which the distributions reasonably are expected to be made. A partnership is unlikely to have perfect projections. The partnership might have a series of different projections (for example, optimistic, pessimistic, mid-range) by different parties. Assuming that all of these projections are reasonable, the largest number among the projections for cumulative distributions over cumulative positive adjustments to capital account should control, even though that number may be projected to occur far in the future and at a time that inflation would make the significance of that future value much less than it appears. No presumption favors a partnership’s good faith efforts to satisfy the alternate test for economic effect.

Partnership projections often are short-term – perhaps three to five years, if that – and imprecise. Partnership projections often are unscientific. Partnership projections often involve Kentucky windage. Projections do not lend themselves to an orderly application of the alternate test for economic effect. Many partnerships and their advisors fudge considerably in applying the alternate test for economic effect.

Many partnerships ignore all of the downward adjustments to capital account under the alternate test for economic effect in applying the alternate test for economic effect. The most common example involves expected distributions of loan proceeds. Another example is when cash may be distributed prior to corresponding income when the partnership uses the completed contracts method. A further example is where a partnership distributes the proceeds of prepaid rents or deposits (which are treated as a loan to the partnership).
The alternate test for economic effect requires precise numbers in order to determine a partner’s capacity to deduct partnership deductions. How the partnership is supposed to obtain sufficiently reliable numbers to apply the alternate test for economic effect is not clear.

The subparagraph (6) adjustment under alternate test for economic effect does not generally consider as projected increases to capital accounts the projected adjustments under the minimum gain chargeback under Treasury Regulations Section 1.704-1(b)(4)(iv)(e) or under Treasury Regulations Section 1.704-2(f). This reflects the fact that a partner’s share of minimum gain already is taken into account under the alternate test for economic effect by being treated as a limited deficit restoration obligation.

Treasury Regulations qualify this general rule by stating that increases to a partner’s capital account under a minimum gain chargeback requirement are taken into account as an offset to distributions of nonrecourse liability proceeds that are reasonably expected to be made and that are allocable to an increase in partnership minimum gain under Treasury Regulations Section 1.704-2(f). This rule permits future distributions of the proceeds of nonrecourse financing without affecting computations under the alternate test for economic effect.

The alternate test for economic effect may be fine as a theoretical construct. Applying the alternate test for economic effect in practice is difficult, except in the most clearly abusive situation. Perhaps a subjective antiabuse test would have been more useful. Perhaps the alternate test for economic effect should be considered as no more than a subjective antiabuse test.

The alternate test for economic effect contains this rule: “For purposes of determining the amount of expected distributions and expected capital account increases described in (6) above, the rule set out in paragraph (b)(2)(iii)(c) of this section concerning the presumed value of partnership property shall apply.” This is a reference to the “value equals basis” rule that you have encountered and repeatedly will encounter in interpreting economic effect and substantiality. The “value equals basis” rule presumes: “For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(iii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. There cannot be a strong

---

likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property.”\textsuperscript{1062} This rule presumably requires that the partnership not rely on anticipated income from the sale of partnership property to create future gain offsets to future cash distributions. Under this construct, there will be no anticipated gain from sale to adjust capital accounts if the fair market value of the property is presumed to decline in accordance with “book” depreciation.

You could carry the “value equals basis” rule even further. The fair market value of partnership property is presumed to decline in accordance with “book” depreciation. This assumption should intrude on the rents which the partnership should receive for its property. This then should affect cash flow projections. The presumed decline in the fair market value of the property similarly should affect the partnership’s capacity to borrow on the security of the partnership property. The partnership similarly cannot distribute as much proceeds of this borrowing if the partnership cannot borrow as much on account of the presumed decline in value of the property in accordance with book depreciation. The “value equals basis” rule perhaps will require us to make realistic projections on future distributions of sale proceeds but to assume that depreciation deductions are not offsetting with gain from sale. The “value equals basis” rule applied to partnership goodwill perhaps could be used to depress projections of future partnership revenue under the theory that future revenues would be low if there were no goodwill (regardless of the actual prospects for future partnership revenues). How extensively the future projections of future distributions and future profits could be distorted by a creative application of the “value equals basis” rule is difficult to know.

The “value equals basis” rule possibly should be limited to the rule that future anticipated partnership distributions cannot be offset by projected gain from sale of partnership property. The “value equals basis” rule projects no gain from sale of partnership property. The application of the “value equals basis” rule to retroactive allocations made after property has been sold or to allocations made after the partnership has contracted to sell property, is untested.

\textbf{vii) Qualified Income Offset.}

Another requirement of the alternate test for economic effect is that the partnership agreement contains a “qualified income offset.”\textsuperscript{1063} No one had heard of a qualified income offset (or QIO) before the publication of Treasury Regulations governing partnership allocations (Section 704(b)). The qualified income offset in effect is an antiabuse provision contained in the partnership agreement.

\textsuperscript{1062} Treas. Reg. § 1.704-1(b)(2)(iii)(c).
\textsuperscript{1063} Treas. Reg. § 1.704-1(b)(2)(iii)(d)(3)
Several formulations of the qualified income offset are set forth in the text in the vicinity of note 616.

The qualified income offset should occur, in ordering allocations in your partnership agreement, after the minimum gain chargeback and partner nonrecourse debt minimum gain chargeback but before other allocations.1064

We earlier have reviewed the requirement of the alternate test for economic effect that allocations will be considered to have economic effect under the alternate test for economic effect to the extent that the allocation does not cause or increase a deficit balance in the partner’s capital account (in excess of any limited dollar amount of such deficit balance that the partner is obligated to restore) as of the end of the partnership taxable year to which the allocation relates. Capital accounts are adjusted downward for this purpose by the adjustments in subparagraphs (4), (5), and (6). These adjustment provide for certain hypothetical reductions in the capital account of the partner receiving the allocation for certain adjustments, allocations or distributions that are reasonably expected to be made, as of the end of the partnership’s taxable year in which the tested allocation is made. These adjustments consider items like reasonably expected depletion allocations, reasonably expected loss and deduction allocations, and reasonably expected distributions in excess of corresponding increases to capital account.1065

Recourse losses and distributions might have reduced a partner’s capital account to a zero balance (or a balance negative to the extent of applicable limited deficit restoration obligations). The partner would have reached the limit permitted under the alternate test for economic effect. Then (or perhaps years in the future), the partner might receive an unexpected adjustment of the type described in subparagraphs (4), (5), and (6) that causes the capital account of the partner to become negative beyond the partner’s deficit restoration or deemed deficit restoration obligation (on account of minimum gain or partner nonrecourse debt minimum gain). The partner would be left with a deficit capital account beyond that

1064 Treas. Reg. § 1.704-1(b)(2)(d) (flush language) (“The partnership agreement contains a “qualified income offset” if, and only if, it provides that a partner who unexpectedly receives an adjustment, allocation, or distribution described in (4), (5), or (6) above, will be allocated items of income and gain (consisting of a pro rata portion of each item of partnership income, including gross income, and gain for such year) in an amount and manner sufficient to eliminate such deficit balance as quickly as possible. Allocations of items of income and gain made pursuant to the immediately preceding sentence shall be deemed to be made in accordance with the partners’ interests in the partnership if requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied.”).

1065 We have reviewed these adjustments above in the text at note 309.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tacitly approved by the alternate test for economic effect. The qualified income offset will apply to eliminate the excess with income allocations.

The qualified income offset provides that, if, and only if, a partner unexpectedly receives an adjustment, allocation, or distribution described in subparagraphs (4), (5), and (6), the partner will be allocated items of income and gain in an amount and manner sufficient to eliminate his deficit capital account balance (beyond the deficit restoration obligation) as quickly as possible. Treasury Regulations could be clearer on this point. The general theory of the qualified income offset would seem to require that capital accounts are reduced for this purpose by reasonably any expected adjustment, allocation, or distribution described in subparagraphs (4), (5), and (6) that reduces capital accounts for purposes of the alternate test for economic effect. Similarly, the deficit balance that the qualified income offset refers to is the deficit in excess of the partner’s actual or deemed deficit restoration obligation. A partner’s share of minimum gain or partner non-recourse debt minimum gain is a deemed deficit restoration obligation for this purpose.

The qualified income offset, if it ever works at all, will create special income allocations in certain circumstances when a partner has a deficit balance (in excess of any limited dollar amount of the deficit balance that the partner is obligated to restore) as of the end of the partnership taxable year. The qualified income offset will apply to the extent that the deficit balance in a partner’s capital account is subject to unexpected –

- Adjustments that are reasonably expected to be made as of the end of the partnership’s taxable year to the partner’s capital account for depletion allowances with respect to oil and gas properties of the partnership,
- Allocations of loss and deduction that are reasonably expected to be made as of the end of the partnership’s taxable year to the partner under the family partnership rules, partnership varying interest rules, and collapsible partnership rules, and
- Distributions that are reasonably expected to be made as of the end of the partnership’s taxable year to the partner to the extent that they exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or before) the partnership taxable years in which the distributions reasonably are expected to be made.1066

---

The qualified income offset applies to a partner who \textit{unexpectedly receives} one of the expected adjustments, allocations or distributions described in subparagraphs (4), (5) or (6). The qualified income offset applies to a partner who \textit{unexpectedly receives} one or more of these adjustments:

- Adjustments that, as of the end of the partnership’s taxable year, \textit{reasonably are expected to be made} to the partner’s capital account for depletion allowances with respect to oil and gas properties of the partnership, and
- Allocations of loss and deduction that, as of the end of the partnership’s taxable year, \textit{reasonably are expected to be made} to the partner under Section 704(e)(2), Section 706(d), and Paragraph (b)(2)(ii) of section 751-1, and
- Distributions that, as of the end of the partnership’s taxable year, \textit{reasonably are expected to be made} to the partner to the extent that they exceed offsetting increases to the partner’s capital account that reasonably are expected to occur during (or prior to) the partnership taxable years in which the distributions reasonably are expected to be made.\footnote{Other than increases under a minimum gain chargeback under Treasury Regulations Section 1.704-1(b)(4)(iv)(e) or under Treasury Regulations Section 1.704-2(f).}

The \textit{unanticipated} receipt of these \textit{reasonably expected} adjustments creates a puzzle. The language of the qualified income offset could benefit from further clarification.

The qualified income offset technically allocates items of gross “book” income when a disparity exists between tax income and “book” income. This allocation of income and gain will consist of a \textit{pro rata} portion of each item of partnership income (including gross income) and gain for the partnership’s taxable year. Taxable income and gain are allocated under Section 704(c) principles in cases of a “book”-tax disparity.

One legitimately could ask: what is an \textit{unexpected} adjustment, allocation, or distribution described in subparagraphs (4), (5), and (6)? These adjustments, allocations, or distributions are often expected at the time when they occur. When must the unexpected adjustment, allocation, or distribution (described in subparagraphs (4), (5), and (6)) be unexpected? One might ask: to who must the adjustment, allocation, or distribution (described in subparagraphs (4), (5), and (6)) be unexpected? How unexpected must the adjustment, allocation, or distribution be? Treasury Regulations provide no direct guidance. The qualified income offset
does not automatically apply just because a distribution forces a partner’s capital account to be negative in an amount in excess of the partner’s actual and deemed deficit restoration obligation.

Partners are inclined to believe that the adjustment, allocation, or distribution described in subparagraphs (4), (5), and (6) must have been unexpected at a time of a prior loss allocation. Loss allocations would have been limited by the alternate test for economic effect if the later adjustment, allocation, or distribution had been expected. While this is an acceptable interpretation of the qualified income offset, this goes well beyond the language of Treasury Regulations. Partnership case law, statutory law and administrative law are not clear on when the qualified income offset does apply. Treasury Regulations could benefit from clarifying amendment. The IRS’ lack of enthusiasm for amending Treasury Regulations may show the IRS’ total lack of interest in the qualified income offset. The IRS likely has no better understanding of the qualified income offset than the ordinary taxpayer has.

k. Partial Economic Effect.

A portion of an allocation made to a partner with respect to a partnership taxable year may economic effect in the sense that it reduces positive capital account or it creates a deficit for which the partner has personal liability. Only a portion of an allocation made to a partner with respect to a partnership taxable year may have economic effect. Then both the portion that has economic effect and the portion that is reallocated consist of a proportionate share of all items that made up the allocation to the partner for the year.1068

l. Economic Effect Equivalence.

Allocations made to a partner that do not otherwise have economic effect are nevertheless can be treated as having economic effect under the economic effect equivalence test. This general rule applies if (as of the end of each partnership taxable year) a liquidation of the partnership (at the end of the partnership’s taxable year or at the end of any future year) would produce the same economic results to the partners as would occur if the three requirements of economic effect had been satisfied, regardless of the economic performance of the partnership.1069

1069 Treas. Reg. § 1.704-1(b)(2)(ii)(i) (“Allocations made to a partner that do not otherwise have economic effect under this paragraph (b)(2)(ii) shall nevertheless be deemed to have economic effect, provided that as of the end of each partnership taxable year a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the part-

(footnote continued on the next page)
Partners’ Interests in the Partnership.

Many allocations will fail the filters of either substantiality or economic effect. Nonrecourse deductions may fail the nonrecourse deduction safe harbor. Income and loss items in that case are to be allocated under the nebulous standard of partners’ interests in the partnership. Treasury Regulations provide only general guidelines concerning the application of the partners’ interests in the partnership test. Some partnership agreements intentionally elect into partners’ interests in the partnership. The draftsmen are concerned about economic problems created by satisfying the rules of substantial economic effect. Treasury Regulations concerning partners’ interests in the partnership do not provide a satisfactory guide to allocations in accordance with partners’ interests in the partnership.

Most tax items allocated in accordance with partners’ interests in the partnership likely will be allocated in a manner as may be necessary to zero-out capital accounts on liquidation if the partnership were maintaining capital accounts in accordance with the rules of Treasury Regulations. The application of the partners’ interests in the partnership test requires a close examination of the economic arrangement among the partners.

Footnote:


1072 Treas. Reg. § 1.704-1(b)(3)(i) (“References in section 704(b) and this paragraph to a partner’s interest in the partnership, or to the partners’ interests in the partnership, signify 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. Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a def-

(footnote continued on the next page)
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING Partnership and LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Proposed Treasury Regulations would eliminate the presumption of equality contained in the current Treasury Regulations.\textsuperscript{1073} The Proposed Treasury Regulations would put nothing in its place.

Treasury Regulations prescribe consideration of these factors:

- The partners’ relative contributions to the partnership,
- The interests of the partners in economic profits and losses (if different from that in taxable income or loss),
- The interests of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation.\textsuperscript{1074}

These factors do not appear at all to consider tax abuse factors that are considered under the test of substantiability. Qualifying allocations under partners’ interests in the partnership may avoid the difficult filters of substantiability entirely. You may have an easier task to qualify some abusive allocations under partners’ interests in the partnership test than under the standard of substantial economic effect. Partners’ interests in the partnership may emancipate the partnership entirely from considerations of substantiability. Certain tax abusive plans might seek to exploit the test of partners’ interests in the partnership and find it a gentler filter than the more rigorous filter of substantial economic effect. At this juncture, however, partnership case law, statutory law and administrative law have not clarified the determination of partners’ interests in the partnership. It is difficult to say how this will be resolved.

\textsuperscript{1073}See REG-144620-04, 70 Fed. Reg. 69919-69922 (November 18, 2005) (“The proposed regulations also remove the per capita presumption in § 1.704-1(b)(3)(i), which reaches the correct result in very few cases.”).

\textsuperscript{1074}Treas. Reg. § 1.704-1(b)(3)(ii).
The law concerning partners’ interests in the partnership still has to be developed. Partners’ interests in the partnership likely usually will allocate partnership items in a manner so that (if the partnership sold all assets and realized the “book” values of all partnership assets in the liquidation (controlled by Section 7701(g), and the partnership then distributed the proceeds in accordance with the liquidation provision in the partnership agreement) the liquidating distribution will zero-out capital accounts. If Treasury Regulations meant this liquidation analysis always to be the standard of partners’ interests in the partnership, that is what Treasury Regulations would have said. They do not.\footnote{1075}

An operational rule is useful. You will not often go wrong if you apply partners’ interests in the partnership by assuming that income and loss allocations under partners’ interests in the partnership are those such that,

- If the partnership were to sell all of its assets at “book” value and to reduce the value of those assets to cash (in the case of assets subject to nonrecourse liabilities in excess of normal fair market value, treating the fair market values of those assets as equal to the amount of nonrecourse liabilities),

\footnote{1075} Another provision concerning partners’ interests in the partnership provides:

\begin{itemize}
  \item[(iii)] Certain determinations. If–
  \begin{itemize}
    \item[(a)] Requirements (1) and (2) of paragraph (b)(2)(ii)(b) of this section are satisfied, and
    \item[(b)] All or a portion of an allocation of income, gain, loss, or deduction made to a partner for a partnership taxable year does not have economic effect under paragraph (b)(2)(ii) of this section, the partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of this section. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(iii) of this section.
  \end{itemize}
\end{itemize}

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The partnership were to liquidate at the end of the taxable year and to distribute the cash in accordance with the provisions in the partnership agreement for distributions in liquidation,
- The partnership were to apply the minimum gain chargeback and the partner minimum gain chargeback (whether or not these provisions are explicitly set forth in the partnership agreement), and
- The partnership were to net remaining “book” income and “book” loss items, then
- The remaining net “book” income or net “book” loss should be allocated under partners’ interests in the partnership in such a manner as is necessary so that every partner ends up with a zero capital account (computing capital accounts in accordance with Treasury Regulations on capital account maintenance, regardless of whether the partnership agreement provides for maintaining capital accounts in accordance with these Treasury Regulations).

This provides a useful operational rule for allocating “book” income and “book” losses in accordance with partners’ interests in the partnership. This rule likely does not work in all cases. Taxable income and taxable losses should follow “book” allocations generally, applying the rules concerning allocating tax items with respect to contributed property (Section 704(c)(1)(a)).

This technique often will not produce the result that the partners expect. Many partnership agreements will return capital contributions to partners before they distribute economic profits. Income will be allocated in accordance with the manner in which the partners share economic income. This is often not the same manner as the manner in which the partnership makes distributions in early years. An allocation in accordance with partners’ interests in the partnership may give a partner substantial allocations of taxable income in years in which the partner receives no distributions.

Consider a partnership in which the limited partners contribute $10 million in cash. The general partner makes no contribution. Under the economic deal, the limited partners in the aggregate are entitled to a 6% preferred return on unrecovered capital and then profits are split 30% to the general partner and 70% to the limited partners. The partnership agreement provides that cash flow, whether by way of operations, is distributed:

- First, to pay the preferred return.
- Second, to return unrecovered capital investments.

\(^{1076}\) See discussion in text as note 644.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

- Third, 30% to the general partner and 70% to the limited partners.

The partnership agreement merely states that all tax items will be allocated in accordance with partners’ interests in the partnership. The partnership has these operating results in years 1 through 6:

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Revenues</th>
<th>Cash Expenses</th>
<th>Depreciation</th>
<th>Taxable Income</th>
<th>Net Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$5,000,000</td>
<td>$1,700,000</td>
<td>$1,000,000</td>
<td>$2,300,000</td>
<td>$3,300,000</td>
</tr>
<tr>
<td>2</td>
<td>$5,350,000</td>
<td>$1,802,000</td>
<td>$1,000,000</td>
<td>$2,548,000</td>
<td>$3,548,000</td>
</tr>
<tr>
<td>3</td>
<td>$5,724,500</td>
<td>$1,910,120</td>
<td>$1,000,000</td>
<td>$2,814,380</td>
<td>$3,814,380</td>
</tr>
<tr>
<td>4</td>
<td>$6,125,215</td>
<td>$2,024,727</td>
<td>$1,000,000</td>
<td>$3,100,488</td>
<td>$4,100,488</td>
</tr>
<tr>
<td>5</td>
<td>$6,553,980</td>
<td>$2,146,211</td>
<td>$1,000,000</td>
<td>$3,407,769</td>
<td>$4,407,769</td>
</tr>
<tr>
<td>6</td>
<td>$7,012,759</td>
<td>$2,274,983</td>
<td>$1,000,000</td>
<td>$3,737,775</td>
<td>$4,737,775</td>
</tr>
</tbody>
</table>

The partnership distributes cash, first, to pay the preferred return, second, to return unrecovered capital investments, and, third, 30% to the general partner and 70% to the limited partners:

<table>
<thead>
<tr>
<th>Year</th>
<th>Net Revenues</th>
<th>Preferred Return to LPs</th>
<th>Return Capital Contributions to LPs</th>
<th>30% to GP</th>
<th>70% to LPs</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$3,300,000</td>
<td>$600,000</td>
<td>$2,700,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>2</td>
<td>$3,548,000</td>
<td>$438,000</td>
<td>$3,110,000</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>3</td>
<td>$3,814,380</td>
<td>$251,400</td>
<td>$3,562,980</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>4</td>
<td>$4,100,488</td>
<td>$37,621</td>
<td>$627,020</td>
<td>$1,030,754</td>
<td>$2,405,093</td>
</tr>
<tr>
<td>5</td>
<td>$4,407,769</td>
<td>$0</td>
<td>$1,322,331</td>
<td>$3,085,438</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>$4,737,775</td>
<td>$0</td>
<td>$1,421,333</td>
<td>$3,316,443</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>$23,908,412</td>
<td>$1,327,021</td>
<td>$10,000,000</td>
<td>$3,774,417</td>
<td>$8,806,974</td>
</tr>
</tbody>
</table>

Under partners’ interests in the partnership, taxable income apparently should be allocated so as to follow the ordering of the allocation of economic profits. Distributions that return capital contributions are return-of-investment distributions and do not return economic profits. It seems that these distributions should be ignored in allocating income. The final two columns appear to be the best index of how the partnership divides economic profits. This chart shows the partnership’s taxable income:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Taxable Income

<table>
<thead>
<tr>
<th>Year</th>
<th>Income</th>
<th>Preferred Return to LP’s</th>
<th>Remaining Income</th>
<th>30% to GP</th>
<th>70% to LP’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$2,300,000</td>
<td>$600,000</td>
<td>$1,700,000</td>
<td>$510,000</td>
<td>$1,190,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$2,548,000</td>
<td>$438,000</td>
<td>$2,110,000</td>
<td>$633,000</td>
<td>$1,477,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$2,814,380</td>
<td>$251,400</td>
<td>$2,562,980</td>
<td>$768,894</td>
<td>$1,794,086</td>
</tr>
<tr>
<td>Year 4</td>
<td>$3,100,488</td>
<td>$37,621</td>
<td>$3,062,867</td>
<td>$918,860</td>
<td>$2,144,007</td>
</tr>
<tr>
<td>Year 5</td>
<td>$3,407,769</td>
<td>$0</td>
<td>$3,407,769</td>
<td>$1,022,331</td>
<td>$2,385,438</td>
</tr>
<tr>
<td>Year 6</td>
<td>$3,737,775</td>
<td>$0</td>
<td>$3,737,775</td>
<td>$1,121,333</td>
<td>$2,616,443</td>
</tr>
</tbody>
</table>

An advisor might naively believe that the annual allocation of taxable income should mechanically follow the distribution of cash. Cash is distributed exclusively to the limited partners in years 1 through 3. This line of reasoning suggests that all taxable income in years 1, 2, and 3 should be allocated to the limited partners during years 1, 2, and 3.

This line of reasoning, however, ignores that the cash distributions in years 1, 2, and 3 merely return invested capital and are not distributions of true economic profits. The economic profits are being allocated first to the preferred return and then 30% to the general partner and 70% to the limited partners. A court likely would determine that taxable income (at least, “book” income) must be allocated in the same way. This chart shows a likely allocation of income in accordance with partners’ interests in the partnership.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

<table>
<thead>
<tr>
<th></th>
<th>Taxable Income</th>
<th>Income Allocation to GP</th>
<th>Cash Distribution to GP</th>
<th>Income Allocation to LP’s</th>
<th>Cash Distribution to LP’s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$2,300,000</td>
<td>$510,000</td>
<td>$0</td>
<td>$1,790,000</td>
<td>$3,300,000</td>
</tr>
<tr>
<td>Year 2</td>
<td>$2,548,000</td>
<td>$633,000</td>
<td>$0</td>
<td>$1,915,000</td>
<td>$3,548,000</td>
</tr>
<tr>
<td>Year 3</td>
<td>$2,814,380</td>
<td>$768,894</td>
<td>$0</td>
<td>$2,045,486</td>
<td>$3,814,380</td>
</tr>
<tr>
<td>Year 4</td>
<td>$3,100,488</td>
<td>$918,860</td>
<td>$1,030,754</td>
<td>$2,181,628</td>
<td>$3,069,734</td>
</tr>
<tr>
<td>Year 5</td>
<td>$3,407,769</td>
<td>$1,022,331</td>
<td>$1,322,331</td>
<td>$2,385,438</td>
<td>$3,085,438</td>
</tr>
<tr>
<td>Year 6</td>
<td>$3,737,775</td>
<td>$1,121,333</td>
<td>$1,421,333</td>
<td>$2,616,443</td>
<td>$3,316,443</td>
</tr>
<tr>
<td>Total</td>
<td>$17,908,412</td>
<td>$4,974,417</td>
<td>$3,774,417</td>
<td>$12,933,995</td>
<td>$20,133,995</td>
</tr>
</tbody>
</table>

It is useful to show the cash flow distributions and the income allocations on a year-by-year basis:

This application of the partners’ interests in the partnership, creates a potential problem for the general partner. The general partner receives no cash distributions in years 1 through 3, yet the general partner is allocated $510,000, $633,000, and $768,894 in income in these three years. This creates a situation in which the general partner may have a substantial tax liability without the means to pay his taxes. The situation can be ameliorated with a special tax distribution provision. Allocation of tax items in accordance with partners’ interests in the partnership often masks the tax problems of service providers and other partners who may be allocated taxable income without immediate corresponding cash.

The proposed allocation of income under partners’ interests in the partnership suggests that the general partner may have troubles coming. The discussion thus far presents partners’ interests in the partnership as a back-door method to achieving economic effect. The methodology presented thus far takes into account only one basic factor – how the proceeds of liquidation will be distributed among the partners. Treasury Regulations on partners’ interests in the partnership mention the partners’ relative contributions to the partnership, the interests of the partners in economic profits and losses (if different from that in taxable income or loss), the interests of the partners in cash flow and other non-liquidating distributions, and the rights of the partners to distributions of capital upon liquidation. We might expect that, if partners’ interests in the partnership were nothing more than a synthetic version of economic effect, that is what Treasury Regulations on partners’ interests in the partnership would have said and that those Treasury Regulations more clearly would have said that partners’ interests in the partnership involves nothing more than a capital account analysis. This suggests that there may be occasions when partners’ interests in the partnership depart from a pure capital account liquidation analysis. This subject, however, is beyond the scope of this Article.
Another troubling question under partners’ interests in the partnership is: how do you allocate nonrecourse deductions? Depending on the economic scheme described under the partnership agreement, partners’ interests in the partnership may describe an annually shifting share of the economic profits and losses of the venture. Does the annual allocation of nonrecourse deductions follow this shifting economic excursion, or is the annual allocation of nonrecourse deductions more stable? Treasury Regulations fail to provide us with more than a clue, and that clue is an odd one. Treasury Regulations provide:

*All partners’ interests in the partnership are presumed to be equal (determined on a per capita basis). However, this presumption may be rebutted by the taxpayer or the Internal Revenue Service by establishing facts and circumstances that show that the partners’ interests in the partnership are otherwise.*

This suggests the possibility that, in the absence of some other clear guideline, the IRS may assert that when the partnership allocates other tax items in accordance with partners’ interests in the partnership, nonrecourse deductions will be allocated among the partners on a *per capita* basis, with each partner receiving an equal allocation. *Per capita* allocations of nonrecourse deductions could substantially disrupt the plans of many partnerships that currently rely on partners’ interests in the partnership. A partner who generally has a 1% economic interest in the partnership might be allocated 50% of the nonrecourse deductions under the *per capita* rule. The uncertainty of how nonrecourse deductions will be allocated among the partners is a major peril for partnerships relying on partners’ interests in the partnership.

142. **Substantiality.**

One aspect of Treasury Regulations on “substantial economic effect” is an attempt to reduce the question of “substantiality” to what appears to be a series of objective mathematical formulas. The formulas offer the beguiling hope that you can just pump in tax and economic data, listen to the low hum, and have the answer to the question of whether the allocation has “substantiality” pop out like fresh toast from a toaster. The “substantiality” toaster does not work so well as that. Treasury Regulations provide the illusion of an objective mathematical approach. The formulas in Treasury Regulations on “substantiality” in fact are unclear. The data is illusive, dependent on perfect knowledge of the future. Treasury Regulations do not provide a direct way for the partnership to access the partner data that is required to implement the tests of “substantiality.”

---

a. Overview of the Problem.

The current final Treasury Regulations on “substantiality” are badly broken — to the point that they cannot be applied rigorously in a broad range of situations even by a capable tax practitioner. The IRS and Treasury appear oblivious to how dysfunctional their Treasury Regulations concerning “substantially” are. Treasury Regulations concerning “substantiality” are understood by neither draftsmen nor auditing agents. These rules are applied by few practitioners as a matter of practice. The defects of Treasury Regulations concerning “substantiality” have practically written this requirement out of Treasury Regulations as a matter of practice. Few IRS audits appear to consider “substantiality” as a major audit issue.

Two of the basic problems are that Treasury Regulations do not effectively address pass-through entities as partners and they do not clearly show the baseline against which the “substantiality” of allocations is tested. Another is that Treasury Regulations establish what on its face appears to be a rigorous mathematical test, but the test is practically impossible to apply. One reasonably could argue that Treasury Regulations concerning “substantiality” are sufficiently complex, uncertain, and difficult to apply that the test of “substantiality” has become substantially a dead letter — an inquiry that neither taxpayers nor the IRS can undertake with any degree of confidence. The result is that neither taxpayers nor the IRS is inclined to undertake the “substantiality” inquiry much at all.

The new Proposed Treasury Regulations on “substantiality”1078 seek to resolve these two problems by making surgical changes to the existing Treasury Regulations. The Proposed Treasury Regulations look through pass-through entities to their partners in applying the rules of “substantiality.” The Proposed Treasury Regulations define the result obtained by partners’ interests in the partnership as the baseline against which “substantiality” of allocations is tested.

The Proposed Treasury Regulations provide merely a cosmetic fix to “substantiality” — fresh lipstick on an old pig. Even with the changes made by the Proposed Treasury Regulations on “substantiality,” Treasury Regulations on “substantiality” are fundamentally unworkable. The test of “substantiality” is practically impossible to apply in the situation of a simple single-tier partnership. Looking through upper-tier pass-through entities does not make the test of “substantiality” any more practical to apply. The test of “partners’ interests in the partnership” is difficult to apply, except in the simplest situations. An objective of ensuring that allocations have “substantiality” is to avoid applying the difficult standard of “partners’ interests in the partnership.” The Proposed Treasury Regu-

---

1078 REG-144620-04 70 Fed Reg. 69919-69922 (November 18, 2005).
lations make the determination of “partners’ interests in the partnership” part of the filter of “substantiality.” This makes the filter of “substantiality” all the more difficult to apply.

The test of substantiality is applied under the “value equals basis” rule that presumes that the value of partnership property declines in accordance with adjustments to its basis – the fair market value of property is equal to its adjusted tax basis (or its “book” value if the two differ). The scope of this rules and whether the presumption can be rebutted is unresolved. One of the effects of this rule is that it is not likely that an early allocation of depreciation will be offset by gain from sale of the same property. The “value equals basis” rule is one of the mysteries of partnership taxation.

Partnership allocations must pass through two basic filters in order to be respected under the basic “substantial economic effect” filter in Treasury Regulations on partnership allocations.

The capital-account-oriented filter of “economic effect” is the more familiar filter to most drafters of partnership agreements. 1079 This filter requires generally that partnership allocations be reflected in capital accounts and that a partner receive the amount in his capital account when he or she withdraws from the partnership or the partnership is liquidated. Most drafters are pleased if their allocations pass-through the filter of “economic effect” and do not worry much beyond that.

The more obscure of the two filters for partnership allocations to have “substantial economic effect” requires that the “economic effect” of partnership allocations must be “substantial.” The existing Treasury Regulations concerning “substantiality” are cryptic and obscure. 1080 Existing Treasury Regulations on “substantiality” have not had much effect on partnership allocations. Few practitioners are likely to be able to apply the rules of “substantiality” to a complicated situation with any confidence of result. “Substantiality” does not seem to have been an effective tool in the hands of the IRS in limiting aggressive allocations.

b. Economic Effect.

An allocation must be consistent with the underlying economic arrangement of the partners in order for the allocation to have “economic effect.” 1081 This translates into the principle that, when an economic benefit or burden corresponds to the allocation, the partner to whom the allocation is made must receive the cor-

---

responding economic benefit or bear the corresponding economic burden. An allocation of income, gain, loss, or deduction (or an item) to a partner generally has “economic effect” if, and only if, throughout the full term of the partnership, three requirements are met. First, the partnership agreement must determine and maintain partners’ capital accounts in accordance with Treasury Regulations’ extensive capital accounting rules.\footnote{1082} Second, all liquidating distributions to the partners must be made in accordance with the positive capital account balances of the partners. Third, each partner must be unconditionally obligated to restore the deficit balance in the partner’s capital account following the liquidation of the partner’s partnership interest.\footnote{1083}

The deficit restoration obligation requirement is relaxed and, in lieu of satisfying the third requirement of “economic effect,” the partnership may satisfy the qualified income offset rules and the alternate test of “economic effect.”\footnote{1084} An allocation can have been treated as having “economic effect” if the allocation satisfies the “economic effect” equivalence rules.\footnote{1085}

c. **Overview of Revised Regulations on “Substantiality.”**

The Treasury Regulations of “substantiality” provide rules for determining the “substantial economic effect” of partnership allocations when the partners are look-through entities or consolidated group members.\footnote{1086} The function of the revised Treasury Regulations is to repair flaws in the current final Treasury Regulations, particularly by providing rules with respect to pass-through entities and providing that “partners’ interests in the partnership” is the baseline against which “substantiality” is tested. Most of the remainder of the revised Treasury Regulations merely repeats the pre-existing Treasury Regulations.

The revised Treasury Regulations provide rules for determining the “substantiality” of an allocation under the partnership allocation rules (Section 704(b)) when the partners are look-through entities or members of a consolidated group, provide additional guidance on the effect of other provisions (for example, Section 482 (rules for reallocating items among related parties)), govern the tax treatment of a partner with respect to the partner’s distributive share (Sec-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

... tion 704(b)), and revise the existing rules for determining the partners’ interests in a partnership. 1087

d. **Basic Filter of “Substantiality.”**

The existing Treasury Regulations on “substantiality” provide generally that the “economic effect” of an allocation is substantial if a reasonable possibility exists that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. 1088

e. **After-Tax Filter of “Substantiality.”**

A refinement or second filter nearly swallows the basic filter of “substantiality” that applies a filter independent of tax consequences. 1089 The after-tax filter of “substantiality” is designed particularly to deal with allocations for partnerships involving partners with tax indifferent partners (for example, foreigners) or partners taxable at low tax rates (perhaps sheltered by net operating losses). This could be considered a test of whether special allocations are tax-motivated, but the after-tax filter of “substantiality” is not written with sufficient care to distinguish tax-motivated special allocations from those that are motivated principally by business considerations. The after-tax filter of “substantiality” in Treasury Regulations represents an effort to objectify what is an inherently subjective inquiry – whether the transaction is motivated by business profit as opposed to tax profit. The inquiry is particularly perilous when one considers the uncertainty of future cash flow, income, and losses, the uncertainty of future tax rates and other tax provisions, and possible future changes in the economics of the partnership. Neither the existing Treasury Regulations nor the revised Treasury Regulations provide much guidance concerning how to resolve these uncertainties. The after-tax filter of “substantiality” requires not only general knowledge of the future, but precise mathematical knowledge about the future so that mathematical filters can be applied. One of the greatest ironies of the after-tax filter of “substantiality,” as articulated in the revised Treasury Regulations, is that the after-tax filter of “substantiality” relies on the nebulous test of “partners’ interests in the partnership.”

The “economic effect” of the allocation (or allocations), under the after-tax filter of “substantiality,” is not substantial under the after-tax filter of “sub-

---


Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Substantiality” if (at the time when the allocation (or allocations) becomes part of the partnership agreement),

- The after-tax economic consequences of at least one partner (in present value terms) may be enhanced compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement, and

- A strong likelihood exists that the after-tax economic consequences of no partner (in present value terms) will be substantially diminished compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement.¹⁰⁹⁰

The after-tax economic benefit or detriment to a partner considers tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership. This leads to an impossible inquiry, particularly as it requires projection into the indefinite future. Many advisors have found the after-tax filter of “substantiality” practically impossible to apply in practice.

We later will put this after-tax filter of “substantiality” on the dissection table and examine the components with a magnifying glass. You will see that this after-tax filter of “substantiality” might be a sound theoretical construct. Treasury Regulations, even as modified by the revised Treasury Regulations, are insufficiently detailed to apply the filter of “substantiality” in practice, except perhaps in the simplest and most abusive situations. Treasury Regulations (and the revised Treasury Regulations) are drafted with little consideration of how to apply the after-tax filter of “substantiality” in practice. Consider that, unless you put a requirement in your partnership agreement requiring partners to provide the necessary tax information to run “substantiality” tests, the partnership may have no way to access this data. A determination by the IRS that allocations in the partnership agreement fail to have substantiality is presumed to be correct. The partnership may not be able to overcome this presumption unless it is able to access taxpayer data. This personal tax data may even by tax data of an indirect partner several tiers above through a series of intervening partnerships. Partners may be reluctant to share their personal tax data with the partnership.

Allocations that fail to have actual or deemed “economic effect” will be respected only if those allocations are in accordance with the “partners’ interests in the partnership.” This filter of partners’ interest in the partnership is nearly as obscure and difficult to apply as the filter of “substantiality.”

¹⁰⁹⁰ Id.
f. Look-through Entities.

The new Treasury Regulations, as revised in 2008, are particularly designed to apply the rules of “substantiality” to the situation of tiered entities when a “look-through entity” is a partner in the partnership making the allocation. These rules, among other things, address situations in which a pass-through entity might be interposed between a tax-indifferent partner (for example, a foreigner or a tax-exempt entity) and the partnership making special allocations. The interaction of a partnership allocation with the tax attributes of owners of look-through entities must be taken into account when determining “substantiality.”

See, generally Treas. Reg. § 1.704-1(b)(2)(iii)(d) (“(d) Partners that are look-through entities or members of a consolidated group – (I) In general. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a look-through entity, the tax consequences that result from the interaction of the allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such a partner, whether directly or indirectly through one or more look-through entities, must be taken into account. For purposes of applying paragraphs (b)(2)(iii)(a), (b), and (c) of this section to a partner that is a member of a consolidated group (within the meaning of § 1.1502-1(h)), the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. . . . (2) Look-through entity. For purposes of this paragraph (b)(2)(iii)(d), a lookthrough entity means – (i) A partnership; (ii) A subchapter S corporation; (iii) A trust or an estate; (iv) An entity that is disregarded for Federal tax purposes, such as a qualified subchapter S subsidiary under section 1361(b)(3), an entity that is disregarded as an entity separate from its owner under §§ 301.7701-1 through 301.7701-3 of this chapter, or a qualified REIT subsidiary within the meaning of section 856(i)(2); or (v) A controlled foreign corporation if United States shareholders of the controlled foreign corporation in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits of the partnership on any day during the partnership’s taxable year. In such case, the controlled foreign corporation shall be treated as a look-through entity, but only with respect to allocations of income, gain, loss, or deduction (or items thereof) that enter into the computation of a United States shareholder’s inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person’s income attributable to a United States shareholder’s inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. See paragraph (b)(2)(iii)(d)(6) for the definition of indirect ownership. (3) Controlled foreign corporations. For purposes of this sec-

(footnote continued on the next page)
analysis of “substantiality” penetrates and looks through look-through entities. Look-through entities flow tax consequences through to their owners. Look-through entities include partnerships, S corporations, trusts, certain controlled foreign corporations, and entities that are disregarded for federal tax purposes (for example, qualified subchapter S subsidiaries, tax-disregarded entities, or qualified real estate investment trusts subsidiaries).  

...
This extension of the “substantiality” analysis makes sense in the abstract. An after-tax test is not usefully applied to a pass-through entity partner. Applying the after-tax tests at the taxpaying entity level by looking through the pass-through entity makes perfect sense. Otherwise, tax planners could use pass-through entities to immunize tax plans from the filter of “substantiality.”

The treatment of pass-through entities under the revised Treasury Regulations expands the scope of the computational problem in applying the after-tax filter of “substantiality.” This includes shareholders of S corporations and partners of upper-tier partnerships in the already difficult computations. The “substantiality” filter is not practical when applied to single-tier partnerships. The treatment of pass-through entities further complicates the “substantiality” filter by requiring extensive tax information and projections from upper-tier partners. The partnerships often may not have access to the required information. Few partnerships require that partners or indirect partners supply the required economic and tax information. Either direct or indirect partners may be reluctant to provide the information necessary for applying the after-tax filter of “substantiality.”

The preamble to Treasury Decision 9398 provides this discussion:

A. Look-Through Entities and Members of a Consolidated Group

For purpose of applying the after-tax, shifting, and transitory tests to a partner that is a look-through entity, the final regulations provide that the tax consequences that result from the interaction of an allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such partner must be taken into account.

The final regulations define a look-through entity as a partnership, subchapter S corporation, trust, estate, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs). The final regulations change the look-through rule for CFCs (CFC look-through rule) to provide an ownership threshold that must be met in order to trigger look-through treatment. One comment suggested that, for administrative reasons, the look-through rule should apply only in cases involving partnerships (whether U.S. or foreign) that meet the control test in section 6038. The IRS and the Treasury Department agree that administrative concerns justify limiting the CFC look-through rule but are concerned that limiting the application of the rule as suggested would provide opportunities for abuse. Accordingly, the final regulations limit application of the CFC look-through rule to cases in which United Stated shareholders (within the meaning of section 951(b)) of the CFC in the aggregate own,
directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.

In addition, the final regulations clarify that a CFC is treated as a look-through entity, but only with respect to allocations of items of income, gain, loss, or deduction that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. The Treasury Department and the IRS are further considering whether a CFC partner should be treated as a look-through entity in all cases and how any impact on the tax liability of a direct or indirect owner of the CFC partner resulting from actual or anticipated distributions of property by the CFC partner under section 301 should be taken into account in testing the substantiality of an allocation.

Comments were also received on other aspects of the look-through rule. One comment suggested that the definition of look-through entity be expanded to include estates. Because estates generally pass through attributes in the same manner as trusts, this comment is adopted. Another comment questioned the inclusion of disregarded entities in the list of look-through entities. The proposed regulations included disregarded entities because such entities are the actual state law partners in the partnership. The final regulations include disregarded entities in the list of look-through entities for this reason only.

Several comments requested modifications to the look-through rule based upon their contention that the rule was burdensome. One comment suggested the abandonment of the look-through rule entirely, believing the application of § 1.701-2 would protect the concerns underlying the proposed regulations and would be less burdensome. Another comment suggested that a five year presumption be included with respect to the after-tax test in § 1.704-1(b)(2)(iii)(a), such that the economic effect of any allocation occurring five years after the date upon which the allocation became a part of the partnership agreement would be presumed to be substantial. Finally, several comments requested either that the look-through rule apply only to partners owning more than 20 percent of the profits or capital of the partnership or that the look-through rule provide procedures to help partnerships ease the burden of considering the tax attributes of their partners and indirect owners.

One proposal to simplify the application of the look-through rule was to include a presumption that the partnership did not know and would
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

not be required to investigate the tax attributes of any partner unless that partner directly or indirectly owns more than a 25 percent interest in the partnership’s capital or profits. Alternatively, it was suggested that the final regulations provide certification procedures pursuant to which a partnership would be entitled to rely on a statement from its direct or indirect owner regarding such person’s tax attributes.

The substantiality test in its present form was adopted in 1986. The Treasury Department and the IRS believe that the final regulations merely confirm the proper application of the substantiality test in those instances in which the partnership is owned by one or more look-through entities. In that respect, the look-through rule in the final regulations is not a change to the substantiality test. The Treasury Department and the IRS do not believe that it is necessary at this time to simplify the application of the substantiality test as suggested by the comments. However, to address the concerns expressed regarding the burden of the substantiality test as it applies to partnerships with look-through entity partners, the final regulations include a de minimis rule that provides that, for purposes of determining substantiality, the tax attributes of de minimis partners need not be taken into account. A de minimis partner is any partner, including a look-through entity, that owns less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item. Because of the inclusion of this de minimis rule, the final regulations do not provide for a certification procedure.

Some comments requested that the final regulations clarify what constitutes a “tax attribute” and an “interaction.” The IRS and the Treasury Department believe that this issue is sufficiently addressed under the current regulations, and, therefore, no further guidance is provided in the final regulations.

Finally, one comment requested that the final regulations provide guidance for situations in which the interaction of an allocation to a look-through entity, such as a trust or estate, and the tax attributes of the beneficiary of the entity are dependent on other factors such as the timing and amount of distributions from the trust or estate to the beneficiary. For example, it may be difficult to evaluate an allocation to a partner that is a trust where it is not known what distributions the trust will make. The IRS and the Treasury Department believe that this issue is addressed by the
 SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

“strong likelihood” language of the substantiality test and, therefore, the final regulations do not provide additional guidance.\textsuperscript{1093}

g. Regulated Investment Companies and Real Estate Investment Trusts.

The preamble to REG-144620-04 (November 18, 2005) explains the current exclusion of regulated investment companies and real estate investment trusts from this treatment of look-through entities:

Although regulated investment companies (RICs) and REITs have certain flow through characteristics, Treasury Regulations do not include them in the list of look-through entities, because the Treasury Department and the IRS believe that the burdens of a rule requiring taxpayers to look through these entities in determining the substantiality of partnership allocations generally would outweigh the benefits of such a rule. However, if necessary, RICs and REITs or other look-through entities may be added to the list of look-through entities in future guidance. Comments are requested regarding the treatment of controlled foreign corporations as look-through partners for purposes of § 1.704-1(b)(2)(iii)(a)(2) of these revised Treasury Regulations. Specifically, comments are requested concerning whether the rule should be limited to those situations in which the controlled foreign corporation owns greater than a threshold minimum percentage interest in the partnership, or only by taking into account the tax attributes of those U.S. shareholders of the controlled foreign corporation owning above a threshold percentage of the stock of the controlled foreign corporation.

Application of look-through treatment to real estate investment trusts and regulated investment companies might make theoretical sense, but it requires projection of their future behavior (whether they will pay tax or pass-through income to shareholders through dividend distributions) and will require knowledge of the tax situation and future economic projections of their shareholders that would make applying the “substantiality” filter oppressively burdensome. Real estate investment trusts and regulated investment companies do not have ready access to the information that would permit application of the “substantiality” rules on a look-through basis. A partnership may have a real estate investment trust or a regulated investment company as a partner.

Partnership case law, statutory law and administrative law do not provide clear guidance on how the rules of “substantiality” are applied to regulated investment companies and real estate investment trusts. The tax effects of an alloc-

Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

tion to a regulated investment company or a real estate investment trust will depend on the behavior of the entity – whether it purges its income with a dividends-paid deduction. Treasury Regulations do not clarify whether allocations to a real estate investment trust or a regulated investment company should be tested based on assuming that the entity will distribute its income or not – or whether the analysis must determine whether the entity is likely to distribute its income. This uncertainly creates doubt in the analysis of the “substantiality” of allocations by a partnership that includes a real estate investment trust or a regulated investment company as a partner.

The preamble to Treasury Decision 9398 explains:

A. Look-Through Entities and Members of a Consolidated Group

For purpose of applying the after-tax, shifting, and transitory tests to a partner that is a look-through entity, the final regulations provide that the tax consequences that result from the interaction of an allocation with the tax attributes of any person that is an owner, or in the case of a trust or estate, the beneficiary, of an interest in such partner must be taken into account.

The final regulations define a look-through entity as a partnership, subchapter S corporation, trust, estate, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs). The final regulations change the look-through rule for CFCs (CFC look-through rule) to provide an ownership threshold that must be met in order to trigger look-through treatment. One comment suggested that, for administrative reasons, the look-through rule should apply only in cases involving partnerships (whether U.S. or foreign) that meet the control test in section 6038. The IRS and the Treasury Department agree that administrative concerns justify limiting the CFC look-through rule but are concerned that limiting the application of the rule as suggested would provide opportunities for abuse. Accordingly, the final regulations limit application of the CFC look-through rule to cases in which United States shareholders (within the meaning of section 951(b)) of the CFC in the aggregate own, directly or indirectly, at least 10 percent of the capital or profits interests of the partnership.

In addition, the final regulations clarify that a CFC is treated as a look-through entity, but only with respect to allocations of items of income, gain, loss, or deduction that enter into the computation of a United States shareholder's inclusion under section 951(a) with respect to the controlled foreign corporation, enter into any person's income attributable to a United States shareholder's inclusion under section 951(a) with respect to
the controlled foreign corporation, or would enter into the computations described in this paragraph if such items were allocated to the controlled foreign corporation. The Treasury Department and the IRS are further considering whether a CFC partner should be treated as a look-through entity in all cases and how any impact on the tax liability of a direct or indirect owner of the CFC partner resulting from actual or anticipated distributions of property by the CFC partner under section 301 should be taken into account in testing the substantiality of an allocation.

Comments were also received on other aspects of the look-through rule. One comment suggested that the definition of look-through entity be expanded to include estates. Because estates generally pass through attributes in the same manner as trusts, this comment is adopted. Another comment questioned the inclusion of disregarded entities in the list of look-through entities. The proposed regulations included disregarded entities because such entities are the actual state law partners in the partnership. The final regulations include disregarded entities in the list of look-through entities for this reason only.

Several comments requested modifications to the look-through rule based upon their contention that the rule was burdensome. One comment suggested the abandonment of the look-through rule entirely, believing the application of § 1.701-2 would protect the concerns underlying the proposed regulations and would be less burdensome. Another comment suggested that a five year presumption be included with respect to the after-tax test in § 1.704-1(b)(2)(iii)(a), such that the economic effect of any allocation occurring five years after the date upon which the allocation became a part of the partnership agreement would be presumed to be substantial. Finally, several comments requested either that the look-through rule apply only to partners owning more than 20 percent of the profits or capital of the partnership or that the look-through rule provide procedures to help partnerships ease the burden of considering the tax attributes of their partners and indirect owners.

One proposal to simplify the application of the look-through rule was to include a presumption that the partnership did not know and would not be required to investigate the tax attributes of any partner unless that partner directly or indirectly owns more than a 25 percent interest in the partnership's capital or profits. Alternatively, it was suggested that the final regulations provide certification procedures pursuant to which a partnership would be entitled to rely on a statement from its direct or indirect owner regarding such person's tax attributes.

The substantiality test in its present form was adopted in 1986. The Treasury Department and the IRS believe that the final regulations merely
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements confirm the proper application of the substantiality test in those instances in which the partnership is owned by one or more look-through entities. In that respect, the look-through rule in the final regulations is not a change to the substantiality test. The Treasury Department and the IRS do not believe that it is necessary at this time to simplify the application of the substantiality test as suggested by the comments. However, to address the concerns expressed regarding the burden of the substantiality test as it applies to partnerships with look-through entity partners, the final regulations include a de minimis rule that provides that, for purposes of determining substantiality, the tax attributes of de minimis partners need not be taken into account. A de minimis partner is any partner, including a look-through entity, that owns less than 10 percent of the capital and profits of a partnership, and who is allocated less than 10 percent of each partnership item. Because of the inclusion of this de minimis rule, the final regulations do not provide for a certification procedure.

Some comments requested that the final regulations clarify what constitutes a “tax attribute” and an “interaction.” The IRS and the Treasury Department believe that this issue is sufficiently addressed under the current regulations, and, therefore, no further guidance is provided in the final regulations.

Finally, one comment requested that the final regulations provide guidance for situations in which the interaction of an allocation to a look-through entity, such as a trust or estate, and the tax attributes of the beneficiary of the entity are dependent on other factors such as the timing and amount of distributions from the trust or estate to the beneficiary. For example, it may be difficult to evaluate an allocation to a partner that is a trust where it is not known what distributions the trust will make. The IRS and the Treasury Department believe that this issue is addressed by the “strong likelihood” language of the substantiality test and, therefore, the final regulations do not provide additional guidance.

h. Consolidated Groups.

The analysis of partners’ after-tax results under the revised Treasury Regulations considers other consolidated items in determining the after-tax economic benefit or detriment to any member of a consolidated group. The analysis takes into account any tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The tax liability of a member of a consolidated group will depend not only on the tax attributes of that partner, but on other items in the consolidated return. This makes sense. Consolidated groups file a single consolidated tax return with a single consolidated tax liability. Of course, this does complicate the mechanics of applying “substantiality.”

i. Reallocation Under Other Provisions.

The revised Treasury Regulations continue the reference in the existing Treasury Regulations that: “[t]he determination of a partner’s distributive share of income, gain, loss, deduction, or credit (or item thereof) under section 704(b) and this paragraph (b) is not conclusive as to the tax treatment of a partner with respect to such distributive share.” While “economic effect” and “substantiality” are important filters in determining partnership allocations, they are not the sole filters in determining partnership allocations, according to the preamble to the revised Treasury Regulations. Allocations that pass the tests of “substantial economic effect” may be disallowed under other provisions or the deductibility of losses may be blocked under other provisions. Losses may be reallocated under such provisions as Section 482, Section 704(e)(2), Section 706(d), the assignment of income rule, and under Section 1.751-1(b)(2)(ii) of Treasury Regulations. Losses may not be deductible under Goldstein v. Commissioner because the partner lacks the requisite profit motive. Losses may be disallowed in the current year and held in suspense for future deductibility under the at risk rules or under the partnership basis limitations. Although not mentioned in the revised Treasury Regulations, the IRS might assert that the Section 701 antiabuse Treasury Regulations will permit the IRS to overrule allocations in the partnership agreement in appropriate circumstances.

The revised Treasury Regulations contain this example. In Example 29, B, a domestic corporation, and C, a controlled foreign corporation, form BC, a part-
nership organized under the laws of country X. B and C each contribute 50 percent of the capital of BC. B and C are wholly-owned subsidiaries of A, a domestic corporation. Substantially all of BC’s income would not be subpart F income if earned directly by C. The BC partnership agreement provides that, for the first fifteen years, BC’s gross income will be allocated 10 percent to B and 90 percent to C. BC’s deductions and losses will be allocated 90 percent to B and 10 percent to C. The partnership agreement provides that, after the initial fifteen year period, BC’s gross income will be allocated 90 percent to B and 10 percent to C. BC’s deductions and losses will be allocated 10 percent to B and 90 percent to C.1098

The revised Treasury Regulations conclude: “Apart from the application of section 704(b), the Commissioner may reallocate or otherwise not respect the allocations under other sections. . . . For example, BC’s allocations of gross income, deductions, and losses may be evaluated and reallocated (or not respected), as appropriate, if it is determined that the allocations result in the evasion of tax or do not clearly reflect income under section 482.”1099 The IRS might seek to use antiabuse Treasury Regulations under Section 721 as a backstop to the “substantiality” filter.

The current Treasury Regulations provide that, in the absence of other guidance, when it is necessary to allocate items in accordance with the “partners’ interests in the partnership,” allocations to each partner are equal. The revised Treasury Regulations end this presumption.

j. Baseline.

The baseline for testing substantiality is the allocation determined in accordance with partners’ interests in the partnership:

This paragraph (b)(2)(iii) to a comparison to consequences arising if an allocation (or allocations) were not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners’ interests in the partnership (within the meaning of paragraph (b)(3) of this section), disregarding the allocation (or allocations) being tested under this paragraph (b)(2)(iii).1100

This provision should prove a challenge to apply. The regulations concerning partners’ interests in the partnership often provide little guidance.

1098 Treas. Reg. § 1.704-1(b)(5), Example (29).
1099 Treas. Reg. § 1.704-1(b)(5), Example (29) (i).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

k. Basic Filter of “Substantiality.”

The basic filter of “substantiality” is stated in the revised Treasury Regulations with modest clarifying changes from the existing Treasury Regulations. Before you explore this too far, remember that the basic filter is subject to a second filter (discussed below).

The economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. This parallels the premise of “economic effect.” An allocation has “economic effect,” as a general matter, if the allocation is reflected in capital accounts and the economics of the partnership are determined by capital accounts.

The Treasury Regulations require that there must be a “reasonable possibility” that the allocation (or allocations) will affect the economics substantially. The meaning of “reasonable possibility” is unresolved. “Reasonable possibility” contrasts with “unreasonable possibility.” This is a statement of probability. “Reasonable possibility” is not a term with a well-established meaning in partnership case law, statutory law and administrative law. “Reasonable possibility” appears to be less than “more likely than not,” perhaps much less than “more likely than not.” “Reasonable possibility” has the flavor of something less than “substantial possibility.” “Reasonable possibility” presumably is more than a “remote possibility.” “Reasonable possibility” perhaps is similar to a “significant possibility.” We do not know precisely (or even approximately) what “reasonable possibility” means.

The “reasonable possibility” must be a reasonable possibility that “the special allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” The allocation (or set of allocations) must have a “reasonable possibility” of substantially affecting the economics of the partnership. Treasury Regulations do not provide clear guidance to how you are to determine that “there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” This apparently requires some sort of projection of future economic consequences and perhaps crystal ball consultation.


The basic filter of “substantiality” should be read in light of the “value equals basis” rule of the final Treasury Regulations on “substantiality”: for pur-

poses of determining “substantiality,” “the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property.” 1102 The “value equals basis” rule assumes that tax depreciation is real and that the value of depreciable property declines in accordance with tax depreciation (or “book” depreciation if a difference between “book” value and adjusted tax basis exists). A gain charge-back allocation will not deprive an earlier allocation of depreciation of “substantiality.” 1103 The “value equals basis” rule is not addressed by the Proposed Treasury Regulations. The “value equals basis” rule is a vulnerability of Treasury Regulations on “substantiality” that could have benefited from further clarification or more radical revision of the existing Treasury Regulations on “substantiality.”

The “value equals basis” rule is completely at variance with economic reality. The “value equals basis” rule ultimately may have the same effect on the construct of Treasury Regulations governing partnership allocations (Section 704(b)) that a pin pricked has on an inflated balloon.

How strong is this presumption?

How is it overcome?

Partnership case law, statutory law and administrative law are not clear in applying the “value equals basis” rule to many situations. The scope of the rule is unresolved. Should the “value equals basis” rule be limited to blessing depreciation deduction allocations? That is not what the “value equals basis” rule says. Does the “value equals basis” rule still apply when the partnership has entered into a contract to sell property? Does the “value equals basis” rule still hold true when the partnership has actually sold property and is undertaking a retroactive allocation at the end of the taxable year – or even subsequent to the end of the taxable year? Depending on its interpretation, the “value equals basis” rule might be an incredible chink in the armor of substantial economic effect that could form the basis of future tax shelters.

---

1103 Id.
The “value equals basis” rule was one of the issues in Revenue Ruling 99-43. Revenue Ruling 99-43 disallowed partnership allocations on the basis of lack of substantiality on account of offsetting special allocations. The ruling holds:

*Partnership special allocations lack substantiality when the partners amend the partnership agreement to specially allocate COD income and book items from a related revaluation after the events creating such items have occurred if the overall economic effect of the special allocations on the partners’ capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement.*

A and B, both individuals, formed general partnership PRS. A and B each contributed $1,000. Each would be allocated a 50-percent share of all partnership items. The partnership agreement provided that PRS must revalue the partnership’s property and adjust the partners’ capital accounts upon the contribution of additional capital by either partner.

PRS borrowed $8,000 from a bank and used the borrowed and contributed funds to purchase nondepreciable property for $10,000. The loan was nonrecourse to A and B and was secured only by the property. (The facts are not entirely clear on whether the loan was nonrecourse to PRS.) No principal payments were due for 6 years. Interest was payable semi-annually. After one year, the fair market value of the property fell from $10,000 to $6,000; the principal amount of the loan remained $8,000. As part of a workout arrangement, the bank reduced the principal amount of the loan by $2,000. A contributed an additional $500 to PRS. A’s capital account was credited with the $500. PRS used these funds to pay currently deductible expenses incurred in connection with the workout. All $500 of the currently deductible workout expenses were allocated to A. B made no additional contribution of capital. B was insolvent within the meaning of Section 108(a) at the time of the workout. B would not be taxable on cancellation of indebtedness income. A and B agreed that, after the workout, A would have a 60-percent interest and B would have a 40-percent interest in the profits and losses of PRS.

PRS had two items to allocate between A and B. The agreement to cancel $2,000 of the loan resulted in $2,000 of cancellation of indebtedness income. A’s contribution of $500 to PRS required PRS, under the partnership agreement, to revalue partnership property and to adjust A’s and B’s capital accounts. The revaluation resulted in a $4,000 economic loss.

---

PRS would have allocated all of the items equally between A and B under the original partnership agreement.

A and B, however, amended the PRS partnership agreement to provide for two special allocations.

- PRS specially allocated the entire $2,000 of cancellation of indebtedness income to B.
- PRS specially allocated the book loss from the revaluation $1,000 to A and $3,000 to B.

B was insolvent. B was indifferent to the cancellation of indebtedness income allocation to him.

The allocation of the $1,000 revaluation loss to A and the $3,000 revaluation loss to B had no direct tax effects upon either A or B. These were allocations of merely a “book” revaluation loss that adjusted capital accounts. When considered with the allocation of $2,000 of cancellation of indebtedness income to B, these special allocations reduce each partner’s capital account to zero.

Revenue Ruling 99-43 observed that PRS was free to reallocate partnership items between A and B in accordance with the partners’ interests in the partnership if the allocations did not have substantial economic effect. B paid no tax on the cancellation of indebtedness income allocation. Without the special allocation, A would have paid tax on the $1,000 of cancellation of indebtedness income allocated under the general ratio for sharing income. A and B amended the PRS partnership agreement to provide for the special allocation of the book loss resulting from the revaluation. Because the two special allocations offset each other, B will not realize any economic benefit from the $2,000 income allocation, even if the property subsequently appreciates in value.

The economics of PRS were unaffected by the paired special allocations. A and B each had a capital account of zero after the capital accounts of A and B were adjusted to reflect the special allocations. The situation of both partners was economically identical to what it would have been had the special allocations not occurred. A strong likelihood existed that the total tax liability of A and B would be less than if PRS had allocated 50 percent of the $2,000 of COD income and 50 percent of the $4,000 book loss to each partner. Revenue Ruling 99-43 concludes that the special allocations of cancellation of indebtedness income and “book” loss are shifting allocations and lack substantiality or transitory allocations if the allocations occur during different partnership taxable years. The conclusion is not changed by the “value equals basis” rule. Revenue Ruling 99-43 states:

*Under that rule, the adjusted tax basis (or, if different, the book value) of partnership property will be presumed to be the fair market value of the property. This presumption is appropriate in most cases because,*
under section 1.704-1(b)(2)(iv), property generally will be reflected on the books of the partnership at its fair market value when acquired. Thus, an allocation of gain or loss from the disposition of the property will reflect subsequent changes in the value of the property that generally cannot be predicted.

The substantiality of an allocation, however, is analyzed “at the time the allocation becomes part of the partnership agreement,” not the time at which the allocation is first effective. See section 1.704-1(b)(2)(iii)(a). In the situation described above, the provisions of the PRS partnership agreement governing the allocation of gain or loss from the disposition of property are changed at a time that is after the property has been revalued on the books of the partnership, but are effective for a period that begins prior to the revaluation. See section 1.704-1(b)(2)(iv)(f).

Under these facts, the presumption that value equals basis does not apply to validate the allocations. Instead, PRS’s allocations of gain or loss must be closely scrutinized in determining the appropriate tax consequences. Cf. section 1.704-1(b)-(4)(vi) [sic]. In this situation, the special allocations of the $2,000 of COD income and $4,000 of book loss will not be respected and, instead, must be allocated in accordance with the A’s and B’s interests in the partnership under section 1.704-1(b)(3).

Close scrutiny also would be required if the changes were made at a time when the events giving rise to the allocations had not yet occurred but were likely to occur or if, under the original allocation provisions of a partnership agreement, there was a strong likelihood that a disproportionate amount of COD income earned in the future would be allocated to any partner who is insolvent at the time of the allocation and would be offset by an increased allocation of loss or a reduced allocation of income to such partner or partners.

Revenue Ruling 99-43 provides support that the “value equals basis” rule is not absolute. The “value equals basis” rule is merely a presumption that can be overcome in at least certain circumstances. Revenue Ruling 99-43 makes the presumption likely to be overcome when the partnership has entered into an agreement to sell the property – or when the partnership already has sold the property and partners seek to undertake retroactive allocations.

Depending on one’s belief in the strength of the “value equals basis,” it may be an overwhelmingly powerful rule that admits all manner of mischief. The rule can become particularly meddlesome when a partner is being retired for some amount different from the amount in his capital account. The “value equals basis” admits the possibility that the partnership may be able to make allocations to retiring partners (through special allocations of income to the retiring partners) that
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

will make retirement payments fully deductible to the partnership. In appropriate circumstances, the partnership might hope to achieve a deduction several times the distribution to the retiring partner (resulting from the retiring partner having a negative capital account). The partnership perhaps could argue that these special allocations are required when the partnership makes allocations in accordance with partners’ interests in the partnership. The matter, however, is in controversy. Full-up allocations almost undoubtedly will be a matter of controversy for some while. 1105

m. Gain Chargebacks.

A gain chargeback provision should not deprive a prior allocation of depreciation from having “substantiality.” The “value equals basis” rule assumes that the tax depreciation will result in corresponding real economic depreciation in the asset. The gain chargeback provision consequently is treated as not affecting the dollar amount that would be distributed to the partners. The allocation of depreciation is treated as real economic loss for purposes of applying the “substantiality” filter. The operation of the “value equals basis” rule in Example 16 below is handy.

Example 16. Jackson Real Estate Partners is a real estate general partnership. The partnership owns an apartment project. The apartment project was acquired with financing that is fully recourse to the partners. The partnership agreement of Jackson Real Estate Partners specially allocates depreciation deductions from the partnership property to one of the partners. The partnership agreement contains a gain chargeback provision that charges first gain on sale of the partnership property to the partner who received a prior allocation of depreciation deductions.

The rôle of the “value equals basis” rule of “substantiality” has not been precisely defined. The “value equals basis” rule is clearly intended to permit gain chargeback provisions and to ensure that they do not offend the “substantiality”

1105 An interesting allocation problems created when a partner is redeemed for a sum that is less than the partner’s pro rata share of the fair market value of partnership assets. This might result from the principle that partnership interests often are valued at a substantial discount from indirect interest in the net fair market value of partnership assets. This can place stress on allocations made in the year of retirement. It also can put stress on allocations in accordance with partners’ interests in the partnership. The exploration of this delightful and important area is beyond the scope of this Article.
filter. The “value equals basis” rule may extend well beyond that. It will be an important development in understanding the rules of partnership taxation when the boundaries of the “value equals basis” rule fully reveal themselves.

n. Fill-up Allocations.

The “fill-up” allocation may be a breakdown – or reflect ambiguities – of Treasury Regulations – and particularly the “value equals basis” rule. “Fill-up” allocations are not addressed by the Proposed Treasury Regulations. The “fill-up” allocation offsets capital gain that the partner otherwise would recognize under Section 731 on account of a cash distribution or a deemed cash distribution under the partnership rules for allocating liabilities among partners (Section 752). The only effects of the “fill-up” allocation are tax effects – to reduce the income of the continuing partners of the partnership. The “fill-up” allocation has no real economic effect on the partners: the partner receiving the “fill-up” allocation receives precisely the same amount of cash in retirement that he would have received in the absence of the “fill-up” allocation. The partner receiving a “fill-up” allocation of capital gain normally will be completely tax indifferent to the allocation. The “fill-up” allocation offsets capital gain that the partner otherwise would recognize on account of the liquidation of his interest in the partnership.

Example 17. The Baker Street Investment Partnership has this balance sheet:

<table>
<thead>
<tr>
<th>Assets</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
<th>Appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$1,750,000</td>
<td>$5,000,000</td>
<td>$3,250,000</td>
</tr>
<tr>
<td>Land</td>
<td>$2,000,000</td>
<td>$2,300,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>Total</td>
<td>$3,750,000</td>
<td>$7,300,000</td>
<td>$3,550,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Capital</th>
<th>Adjusted Basis</th>
<th>Fair Market Value</th>
<th>Appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>$3,000,000</td>
<td>$3,000,000</td>
<td>$0</td>
</tr>
<tr>
<td>Capital – Mr. Watson</td>
<td>$225,000</td>
<td>$1,290,000</td>
<td>$1,065,000</td>
</tr>
<tr>
<td>Capital – Mr. Blessington</td>
<td>$300,000</td>
<td>$1,720,000</td>
<td>$1,420,000</td>
</tr>
<tr>
<td>Capital – Mr. Bruce</td>
<td>$225,000</td>
<td>$1,290,000</td>
<td>$1,065,000</td>
</tr>
<tr>
<td>Total</td>
<td>$3,750,000</td>
<td>$7,300,000</td>
<td>$3,550,000</td>
</tr>
</tbody>
</table>

See discussion of the “value equals basis” rule in text at note 1102. The “value equal basis” rule may be important for “boot” allocations for like-kind exchanges by partnerships.
Mr. Watson is a 30% partner. Mr. Blessington is a 40% partner. Mr. Bruce is a 30% partner.

Baker Street exchanges its building and land in a transaction qualifying for nonrecognition under Section 1031. Baker Street receives $1,720,000 in cash in addition to $6,010,000 in replacement property. Baker Street recognizes $1,720,000 in gain on account of the cash. Baker Street distributes the $1,720,000 in cash to Mr. Blessington in retirement of his interest in Baker Street. Immediately before disposing of the relinquished property, but after Baker Street enters into the sale agreement, the partners amend the Baker Street partnership agreement of to allocate the gain resulting from the cash in this manner:

<table>
<thead>
<tr>
<th></th>
<th>Mr. Watson</th>
<th>Mr. Blessington</th>
<th>Mr. Bruce</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Account Before Allocation</td>
<td>$225,000</td>
<td>$300,000</td>
<td>$225,000</td>
</tr>
<tr>
<td>Cash Distribution</td>
<td>$0</td>
<td>$1,720,000</td>
<td>$0</td>
</tr>
<tr>
<td>Gain Allocation</td>
<td>$150,000</td>
<td>$1,420,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Capital Account After Allocation</td>
<td>$375,000</td>
<td>$0</td>
<td>$375,000</td>
</tr>
</tbody>
</table>

The true economics of Baker Street remain completely unchanged, notwithstanding the special allocation: Mr. Watson is a 30% partner, Mr. Blessington is a 40% partner, and Mr. Bruce is a 30% partner.

This is what is often referred to as a “fill-up” allocation. Mr. Blessington is allocated enough gain so that he receives a liquidating distribution equal to the balance in his capital account – or, in other words, he receives an income or gain allocation so that, after the allocation, his capital account is equal to the amount that he will receive in liquidation. The allocation does not truly affect the amount that Mr. Blessington will receive – except in the same that it has the effect of re-valuing Mr. Blessington’s capital account to its fair market value. Baker Street has merely revalued Mr. Blessington’s capital account to his 40% interest in the net value of Baker Street’s property. Mr. Blessington receives the same 40% share of the value of Baker Street that he would receive in the absence of the allocation of gain. The complete lack of realistic “economic effect” calls attention to the validity of the allocation. Furthermore, the allocation of capital gain to Mr. Blessington is unlikely to have any tax effect on Mr. Blessington. The allocation increases Mr. Blessington’s basis in his partnership interest. The increase in basis offsets gain that Mr. Blessington otherwise would recognize on the liquidation of his partnership interest. This is the perfect allocation from the viewpoint of the continuing partnership: the allocation reduces the taxes of the continuing partners at no cost to the retiring partner and at no cost to Baker Street. The allocation puts Mr. Blessington in a position roughly similar to the position that he would be in if Mr. Blessington owned an undivided interest in the property.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The adjustment to Mr. Blessington’s capital account and distribution to Mr. Blessington of cash equal to the amount in his capital account comports with the capital account liquidation principle of “economic effect.” The status of this allocation under the basic filter of “substantiality” is unresolved.\textsuperscript{1107}

“Substantiality” requires that: “Except as otherwise provided in this paragraph (b)(2)(iii), the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” The allocation to Mr. Blessington does not realistically affect the amount of cash that Mr. Blessington receives in retirement of his partnership interest. The allocation may not pass through the filter of “substantiality.” The allocation does not at all affect the amount that Mr. Blessington receives. The land and building are worth only $3,750,000 rather than $7,300,000 immediately prior to the sale if you accept the premise of the “value equals basis” rule. The net worth of the partnership increases by only $1,720,000 on account of the exchange – under the theory of the “value equals basis” rule. This increase in net worth is allocated in accordance with the allocation of exchange gain. The allocation of “boot” gain on the exchange fully accords with partnership economics if you believe the “value equals basis” rule. Mr. Blessington receives substantially more in dollar amount on account of the allocation – if you believe the “value equals basis” rule.

Several objections can be made to the application of the “value equals basis” rule to fill-up allocations. The “value equals basis” rule is merely a presumption. The “value equals basis” rule, by its terms, is not a conclusive presumption. Treasury Regulations do not expressly say that the “value equals basis” rule is a particularly strong presumption. The reality of the impending sale of the property should overcome this presumption, or so one might argue. This argument, however, may not persuade: the “value equals basis” rule seems to be applied by Treasury Regulations to depreciation allocations and gain chargebacks as if the “value equals basis” rule is a conclusive presumption.

The full scope of the “value equals basis” rule is not clearly illustrated in Treasury Regulations – and is not entirely clear. The “value equals basis” rule makes sense to permit gain chargebacks of prior depreciation deductions. The presumption perhaps should not be extended beyond income chargebacks. The

\textsuperscript{1107}Mr. Blessington has a positive capital account prior to the fill-up allocation. The analysis is a bit different if Mr. Blessington has a negative capital account prior to the special allocation. The analysis of the fill-up allocation is dependent on the allocation adjusting Mr. Blessington’s capital account to the amount of cash that he will receive in retirement of his partnership interest.
“value equals basis” rule is particularly inappropriate after the partnership has entered into an agreement to sell property or after the partnership has exchanged property in a nontaxable exchange. The “value equals basis” rule was not clearly intended to be applied to permit a fill-up allocation when the partnership has contracted to sell property for an amount substantially above tax basis. The “value equals basis” rule similarly does not clearly apply to permit a fill-up allocation after the partnership has already exchanged property for an amount substantially above tax basis and received a replacement property in exchange. Applying the “value equals basis” rule after an exchange strains the presumption. The “value equals basis” rule often flies in the face of economic reality and the principle that “the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” The fill-up allocation of capital gain is suspect. This fill-up allocation does not affect Mr. Blessington’s tax liability. The capital gain fill-up allocation to Mr. Blessington merely offsets capital gain that Mr. Blessington’s otherwise would recognize on the liquidation of his interests in the Baker Street Investment Partnership. The allocation has absolutely no effect beyond its tax effect.

The “fill-up” allocation presents a question similar to the question of whether Baker Street Investment Partnership should be able to deduct redemption payments to Mr. Blessington. The allocation has much of the effect of permitting Baker Street Investment Partnership to deduct the retirement payments to Mr. Blessington (albeit at capital gain rates in the current situation). Many retirement payments were deductible under Section 736(a)(2) under prior law, but this provision was substantially limited in 1978 by amendments to Section 736(b)(3). Payments to a retiring partner or a deceased partner on account of unrealized receivables of the partnership or good will of the partnership (to the extent that the partnership agreement does not provide for a payment with respect to good will) are not treated as a distributive share of partnership income if either (i) capital is a material income-producing factor for the partnership, or (ii) the retiring or deceased partner was not a general partner in the partnership. Reconciling the “fill-up” allocation with the policy underlying this restriction – the recognition that retirement payments generally should not be deductible to the partnership – is difficult.

1108 In appropriate circumstances, the redeeming partnership will be allocating ordinary income to the retiring partner, which will have the effect of creating an ordinary deduction to the partnership on account of retirement payments.
1109 I.R.C. § 736(b)(3).
The allocation in Example 17 is likely to attract sympathy from a substantial audience of advisors and taxpayers. Mr. Blessington receives the cash from the exchange. The gain is closely associated with the cash. A certain intuitive sense suggests that Mr. Blessington should bear the tax liability from the gain that produces the cash that Mr. Blessington receives. The fill-up allocation does not allocate all of the “boot” gain to Mr. Blessington, but the fill-up allocation allocates most of the gain to him. The allocation (if Mr. Blessington starts out with a positive capital account) puts Mr. Blessington in roughly the same position that he might have been in if Mr. Blessington had owned the property as a tenant in common rather than as a partner.

Baker Street Investment Partnership might make a fill-up allocation well in excess of its retirement payments to Mr. Blessington if Mr. Blessington had a substantial negative capital account prior to the allocation and Baker Street Investment Partnership had sufficient other capital gain items (or perhaps ordinary income items) to allocate to Mr. Blessington as a fill-up allocation. A partner might receive only a small amount in retirement, have a substantial negative capital account, and receive a substantial fill-up allocation from either capital gain or operating income in order that the partner is retired in accordance with his capital account balance. A “value equals basis” rule enthusiast or fill-up allocation enthusiast might be supportive of this allocation.

The reasoning that supports applying the “value equals basis” rule to the allocation to Mr. Blessington in Example 17 might support a fill-up allocation of capital gain (or perhaps ordinary income) to any retiring partner. A partnership with capital gain items in the partnership’s taxable year of liquidation of a partner could make a sweeping allocation of enough of its capital gain so that the retiring partner’s capital account is equal to the amount that the partner will receive in retirement. This allocation will satisfy the requirement of “economic effect” that capital accounts determine partnership economics. The fill-up allocation has the same “economic effect” as a revaluation of capital accounts on account of the liquidation. The retiring partner should not particularly care about the allocation. The allocation will merely offset capital gain that the partner otherwise would recognize on retirement of his partnership interest. The fill-up allocation can provide a deduction at capital gain rates for a substantial portion of the retirement


1111 The alternative technique of revaluing capital accounts and then allocating gain to the retiring partner under Section 704(c)(1)(A) is an important subject, but outside of the scope of the current Article.
Some comments on how to compromise drafting partnership and LLC agreements and some basic issues in drafting real estate partnership and LLC agreements

payments. Any partnership retiring a partner might seek a capital gain fill-up allocation to the retiring partner if this fill-up allocation works. The deduction might dramatically exceed the retirement payments to the retiring partner when the retiring partner had a large deficit capital account prior to the allocation. This promises to make retirement payments deductible at capital gain rates. Retiring a partner (especially a tax-indifferent partner) can be used to produce a self-help tax shelter if the allocation works.

Some advisors might argue that the result in Example 17 could have been reached if the partnership had revalued the partnership property and allocated a disproportionate share of the gain under principles of the partnership tax rules governing allocations of tax items when a “book”-tax disparity exists (Section 704(c)). This argument and its analysis are beyond the scope of this Article. This approach, if permitted, requires a preferential allocation of income to one partner under the partnership tax rules governing allocations of tax items where a “book”-tax disparity exists (Section 704(c)), even though all partners shared in the revaluation adjustment.

The American Bar Association Taxation Section in comments to Treasury have proposed the “value equals basis” rule should apply to permit a fill-up allocation in the context of a Section 1031 exchange. In the example, ABC limited liability company (“LLC”) was formed in 199X by individuals A, B and C, each of whom contributed $100,000 in cash in exchange for a one-third interest in the profits, losses and capital of LLC. The operating agreement for LLC provides that allocations of income, gain, loss and deduction are reflected in the member’s respective capital accounts, and liquidating distributions (including in complete retirement or redemption of a member’s interest would be made in accordance with the member’s capital account balances). LLC purchased Whiteacre, a rental office building, for $300,000 in cash. In 200X, the adjusted tax basis of Whiteacre has been reduced to $200,000 through straight line depreciation deductions and the fair market value of Whiteacre had increased to $600,000. At that time, A agrees with B and C that A’s one-third interest in LLC should be fully retired and liquidated for the amount of $200,000, representing one-third of the fair market value of the assets of LLC. LLC enters into a contract to exchange Whiteacre for Blackacre, which has a fair market value of $400,000, plus $200,000 in cash. Immediately before the exchange, the capital account of each of A, B and C is $66,667.

1112 The matter is more complicated where the partnership holds ordinary income assets on account of the collapsible partnership rules of Section 751. The partnership nevertheless might hope to achieve (through a fill-up allocation) an ordinary deduction for a significant portion of retirement payments (with the retiring partner recognizing ordinary income and a capital loss).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The LLC has no other significant assets and no liabilities at that time. Immediately prior to the closing of the exchange, A, B and C agree to modify their operating agreement for LLC such that $133,333 of the “boot” gain recognized in the exchange for Blackacre and $200,000 in cash is specially allocated to A, increasing her capital account to $200,000. (In the Section 1031(b) exchange, LLC will realize $400,000 of gain, of which $200,000 will be recognized.) The remaining $66,667 of “boot” gain is allocated equally to B and C. A agrees to accept a cash distribution of $200,000 from LLC in complete retirement of A’s interest in the LLC. B and C agree to continue the LLC indefinitely as equal members. B and C intend that the LLC will hold Blackacre for productive use in LLC’s trade or business.

The American Bar Association analysis concludes that the “value equals basis” rule blesses the proposed special allocation of gain to the partner who receives the cash. They reason:

The disproportionate allocation of $133,333 of gain to A and $66,667 to B and C should be recognized as a valid Section 704(b) allocation because the allocation has substantial economic effect and is consistent with the respective partner interests of A, B and C under two alternative tax analyses. . . .

The economic effect of the disproportionate allocation of boot gain to A is substantial because the second to the last sentence in Treas. Reg. section 1.704-1(b)(2)(iii)(c) (i.e., the so-called “value-equals-basis rule”) provides that “for purposes of section 1.704-1(b)(2)(iii), the adjusted basis of partnership property . . . will be presumed to be the fair market value of such property, and adjustments to the adjusted basis of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there can not be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by gain or loss from the disposition of property.” Accordingly, because at the time of the special gain allocation, it is assumed that the fair market value and adjusted basis of Blackacre are $200,000 and neither the IRS nor ABC could presume the existence of $200,000 of gain inherent in Blackacre to “charge back” to B and C. Thus, B and C are deemed to bear the burden of the disproportionate gain allocation to A in the form of a relatively smaller increase in the capital account balances of B and C. Objective facts indicating that Blackacre actually retained its fair market value of $400,000 are ignored under the value-equals-basis analysis.

The American Bar Association report does not discuss the strength of the presumption of the “value equals basis” rule, although the report implicitly assumes that the presumption is strong or perhaps irrebuttable. The report does not expressly discuss whether the “value equals basis” rule was intended to apply
when property is under contract for sale (or perhaps has recently been purchased in an exchange for an amount far in excess of its “book” value). The American Bar Association report implicitly suggests that the “value equals basis” rule will resist any objective facts. The report does not address the situation when the retiring partner receiving the fill-up allocation starts with a deficit capital account. The American Bar Association report approach suggests the possibility of using gain allocations to produce a form of synthetic revaluation of the capital account of the retiring partner. Whether the courts will be sanguine to this interpretation of the “value equals basis” rule remains to be seen. Treasury Regulations could benefit from clarification.\footnote{1113}

The basic filter of “substantiality” provides: “the economic effect of an allocation (or allocations) is substantial if there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.”\footnote{1114}

The allocation (or allocations) not only must affect the dollar amounts distributed by the partnership, independent of tax consequences, but the allocation must affect the dollar amounts “substantially.” This might create doubt concerning small special allocations. Small allocations arguably do not affect the dollar amounts of distributions substantially. Advisors may puzzle over precisely what it means to “affect substantially the dollar amount to be received by the partners from the partnership.” Can a small allocation “affect substantially the dollar amount to be received by the partners from the partnership”? The answer is unresolved.

\textit{Example 18.} Assume that no gain is recognized in the exchange in the American Bar Association example set forth above. The partnership fully reinvests all cash in replacement property. The partnership has $200,000 of gross ordinary income from operations. Immediately prior to the closing of the exchange, A, B and C agree to modify their operating agreement for LLC such that $133,333 of the operating ordinary income and $200,000 in cash is specially allocated to A, increasing her capital account to $200,000. The remaining $66,667 of operating ordinary income is allocated equally to B and C. A agrees to accept a cash distribution of $200,000 from LLC in complete retirement of A’s interest in the LLC. B and C agree to continue the LLC indefinitely as equal members. B and C intend that the LLC will hold Blackacre for productive use in LLC’s trade or business.

\footnote{1113}{Another technique is to revalue the property and to seek to allocate the recognized gain to the withdrawing partner under the principles of Section 704(c). This technique is not certain to prevail under Section 704(c). A discussion of this technique is outside of the scope of this Article.}
\footnote{1114}{Prop. Treas. Reg. § 1.704-1(b)(2)(iii)(a)(I).}
The allocation has “economic effect”: A receives the amount in her capital account. The allocation may have “substantiality” if you accept the premise of the “value equals basis” rule. The “value equals basis” rule assumes that the property has declined in value in accordance with the depreciation in its adjusted tax basis. Extending the reasoning of the American Bar Association report, “B and C are deemed to bear the burden of the disproportionate gain allocation to A in the form of a relatively smaller increase in the capital account balances of B and C. Objective facts indicating that Blackacre actually retained its fair market of $400,000 are, therefore, ignored under the value-equals-basis analysis.” The partnership effectively will have made $133,333 of the payments to A deductible if the allocation survives the filter of “substantiality.” A then will suffer ordinary income treatment, but will have a capital loss. This example is not specifically endorsed by the American Bar Association report, but the example might be justified by an extension of the reasoning of the American Bar Association report.

Example 19. Assume that no gain is recognized in the exchange in the American Bar Association example set forth above. The partnership fully reinvests all cash in replacement property. Before the allocation, A has a capital account of negative $1 million. The partnership has $1,200,000 of gross ordinary income from operations. Immediately prior to the closing of the exchange, A, B and C agree to modify their operating agreement for LLC such that $1.2 million of the operating ordinary income and $200,000 in cash is specially allocated to A, increasing her capital account to $200,000. A agrees to accept the cash distribution of $200,000 from LLC in complete retirement of A’s interest in the LLC. B and C agree to continue the LLC indefinitely as equal members. B and C intend that the LLC will hold Blackacre for productive use in LLC’s trade or business.

The allocation in Example 19 satisfies “economic effect.” The allocation helps the other partners. The allocation effectively creates a substantial deduction to them on account of A’s retirement. The allocation may satisfy the basic filter of “substantiality” on account of the “value equals basis” rule. One may accept the premise of the “value equals basis” rule. It is at least arguable that “there is a reasonable possibility that the allocation (or allocations) will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.” This matter, however, is unresolved. The allocation does not affect the amount that A will receive. The IRS is not likely to be sanguine to the allocation in Example 19. This example shows the “value equals basis” rule abused.

o. After-Tax Filter of “Substantiality.”

Notwithstanding the basic filter of “substantiality,” an after-tax filter of “substantiality” considers after-tax consequences in evaluating “substantiality.” This after-tax filter provides: “Notwithstanding the [basic filter], the economic effect of an allocation (or allocations) is not substantial if, at the time the alloca-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tion (or allocations) becomes part of the partnership agreement, the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners’ interests in the partnership), and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners’ interests in the partnership). In determining the after-tax economic benefit or detriment to a partner, tax consequences that result from the interaction of the allocation with such partner’s tax attributes that are unrelated to the partnership will be taken into account.”

The after-tax filter of “substantiality” is a second additional filter that is applied in series with the basic filter. An allocation must pass through both the basic filter and the after-tax filter in order to be respected as having “substantiality.” Passing through only one filter is not enough for an allocation to have “substantiality.”

The language of the after-tax filter of “substantiality” is quite a lot to swallow in one gulp. You can cut the language of the after-tax filter into smaller morsels and digest it more carefully as part of a leisurely meal.

Parsing the after-tax filter of “substantiality,” you have:

- The “economic effect” of an allocation (or allocations) is not substantial if (at the time the allocation (or allocations) becomes part of the partnership agreement),
- The after-tax economic consequences of at least one partner may be enhanced (in present value terms) compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement, and
- A strong likelihood exists that (i) the after-tax economic consequences of no partner will (in present value terms) be substantially diminished compared to (ii) the after-tax economic consequences to the partner if the allocation (or allocations) were not contained in the partnership agreement.

---

1115 Id.
1116 Id.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

The baseline against which the “substantiality” of an allocation is compared is how items would be allocated in accordance with “partners’ interests in the partnership.”

The computations of the after-tax filter of “substantiality” consider tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership. This interaction with the partner’s unrelated tax attributes is perhaps the most difficult part of the after-tax filter. This requires projections of the partner’s unrelated tax attributes perhaps for many years into the future. The after-tax filter of “substantiality” requires considerable information about each partner’s current and future tax items. Partnerships normally do not have access to this intimate information concerning each of their partners. One reasonably might ask: how is the partnership supposed to obtain this information about its partners? Is this something that should be addressed in drafting partnership agreements? Even if the partnership has the right to compel partners to produce current information, how does the partnership produce future tax information about its partners as might be required to produce after-tax projections? How is the IRS, for that matter, to obtain enough future tax information about the partners so that the IRS can develop useful projections? Perhaps partnerships should include an obligation to supply this information as a standard term in partnership agreements and LLC operating agreements. A basic problem, however, is that partners will not want to share personal tax information (or tax projections) with their partners. This information often is very sensitive. The substantiality regulations do not appear to consider the confidentiality and sensitivity of this information.

The after-tax filter of “substantiality” is applied at the time when the allocation (or allocations) becomes part of the partnership agreement.

The allocation (or allocation) fails “substantiality” under the after-tax filter if—

• Some partner might be better off on account of the allocation (or allocations), and

• A strong likelihood exists that no partner will be substantially worse off on account of the allocation (or allocations).

This is all measured on an after-tax, present value basis, considering all partner items both from the partnership and from other sources.

You can observe that an allocation that fails the basic filter of “substantiality” never will reach the after-tax filter of “substantiality.” This at least simplifies the inquiry.

The after-tax filter of “substantiality” does not parse well. In the vernacular of the outdoorsman, this dog won’t hunt. The task of applying the after-tax fil-
ter of “substantiality” becomes insuperable as the number of partners increases. One can imagine the challenge of analyzing “substantiality” of an allocation in the partnership agreement of a major national accounting firm. This could require forward projections of not only partnership operations but also the nonpartnership items of the various partners indefinitely into the future. The inquiry might result in the need to undertake millions of individual computations and could require incredibly massive and difficult projections.

p. Present Values.

The after-tax filter of “substantiality” examines the present values of future after-tax economic tax consequences. The after-tax filter of “substantiality” first asks whether the after-tax economic consequences of at least one partner may be enhanced (in present value terms) compared to the consequences if the allocation (or allocations) were not contained in the partnership agreement. This compares (i) the after-tax economic consequences of the partner (in present value terms) with the allocation (or allocations) to (ii) the after-tax economic consequences (in present value terms) if the allocation or allocations were allocated among the partners in accordance with the “partners’ interests in the partnership.” The after-tax filter of “substantiality” takes into account tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership in determining the after-tax economic benefit or detriment to a partner.

q. After-Tax Effects.

The after-tax filter of “substantiality” next determines the after-tax economic consequences of the allocation (or allocations), in present value terms. The after-tax filter of “substantiality” then determines the after-tax economic consequences (in present value terms) to each partner if the allocation or allocations were allocated among the partners in accordance with the “partners’ interests in the partnership.” The after-tax filter of “substantiality” takes into account tax consequences that result from the interaction of the allocation with the partner’s tax attributes that are unrelated to the partnership in determining the after-tax economic benefit or detriment to a partner. This requires reliable forward projections of unrelated tax attributes for the partner perhaps well into the future.

r. Comparison to “Partners’ Interests in the Partnership.”

The after-tax filter of “substantiality” compares after-tax results with the allocation to after-tax results without the allocation. The after-tax filter of “substantiality” requires determining “[present value after-tax economic] consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners’ interests in the partnership).” This requires determination of the results if “the allocation or allocations were allocated among the
partners in accordance with the partners’ interests in the partnership.” Neither the
existing final Treasury Regulations nor the Proposed Treasury Regulations pro-
vide any guidance concerning how to make this determination. Presumably, this
inquiry starts with the various cash flow allocations and asks for the allocation
result determined in accordance with “partners’ interests in the partnership.” The
irony is that this makes it necessary to determine allocations in accordance with
partners’ interests in the partnership in order to determine whether allocations
have “substantial economic effect.” Few draftsmen have any particular affinity for
determining allocations in accordance with “partners’ interests in the partnership”
when allocations are complex.\footnote{One case that illustrates the difficulty of applying the filter of “sub-
stantiality” is TIFD III-E Inc. v. United States, 342 F. Supp. 2d 94 (D. Conn. 2004), rev’d
459 F.3d 220 (2d Cir. 2006) (“Castle Harbour” case) (IRS asserted that in deter-
mining partners’ interests in the partnership, allocation should be compared to
allocation of income and loss in accordance with capital percentages; court dis-
agreed; on appeal, the appellate court found that interests of certain purported par-
tners were merely participating loans and that purported partners were not bona
fide equity partners for tax purposes; “the Dutch banks’ interest was overwhelm-
ingly in the nature of a secured lender’s interest, which would neither be harmed
by poor performance of the partnership nor significantly enhanced by extraordi-
ary profits. The banks had no meaningful stake in the success or failure of Castle
Harbour. While their interest was not totally devoid of indicia of an equity partic-
ipation in a partnership, those indicia were either illusory or insignificant in the
overall context of the banks’ investment. The IRS appropriately rejected the equi-
ty characterization.”). Taxpayer’s counsel filed a petition for en banc rehearing
before the Second Circuit Court of Appeals on September 18, 2006. The petition-
er’s brief argues: “a holding that interests with the characteristics at issue here, as
found below and as amply supported by the record, are not bona fide equity
would have serious repercussions for the Nation’s capital markets.” See 2006
TNT 188-17 (Sept. 18, 2006). See also Treas. Reg. § 1.704-1(b)(5), Example 9 (R
contributes 90 percent of partnership capital Q contributes 10 percent of partne-
ship capital, cash is distributed 90 percent to Q and 10 percent to R income is
generally allocated 90 percent to Q and 10 percent to R; for eight years, income is
allocated 90 percent to Q (entity with net operating losses) and 10 percent to R;
during this period, Q receives greater distributions; example assumes that base
against which “substantiality” is measured is income allocation of 90 percent to R
and 10 percent to Q). Cf. Treas. Reg. § 1.704-1(b)(5), Example (1)(i), (iv), (v),
Example (5), Example (8)(i), Example (11)(i), (ii), Example (12)(i), (ii), Example
(14)(i), (ii), (iii), (vii), Example (15)(ii), (iii), Example (16)(i), Example
(17), Example (18)(iii), (iv), (v), (vi), (vii), (ix), (x), (xi), (xii), Example (19)(iii).}
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The law concerning “partners’ interests in the partnership” is not well-developed. Treasury Regulations clarify that:

*a partner’s interest in the partnership, or to the partners’ interests in the partnership, [means] 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.*

Except with respect to partnership items that cannot have economic effect (such as nonrecourse deductions of the partnership), this sharing arrangement may or may not correspond to the overall economic arrangement of the partners. Thus, a partner who has a 50 percent overall interest in the partnership may have a 90 percent interest in a particular item of income or deduction. (For example, in the case of an unexpected downward adjustment to the capital account of a partner who does not have a deficit make-up obligation that causes such partner to have a negative capital account, it may be necessary to allocate a disproportionate amount of gross income of the partnership to such partner for such year so as to bring that partner’s capital account back up to zero.) The determination of a partner’s interest in a partnership shall be made by taking into account all facts and circumstances relating to the economic arrangement of the partners. . . .

The “substantiality” inquiry applies these factors:

- The partners’ relative contributions to the partnership,
- The interests of the partners in economic profits and losses (if different from that in taxable income or loss),
- The interests of the partners in cash flow and other non-liquidating distributions, and
- The rights of the partners to distributions of capital upon liquidation.

Treasury Regulations do not tell us precisely how you apply these factors.

When the partnership agreement complies with capital account maintenance under the Section 704(b) Treasury Regulations and distributes to a partner in liquidation the amount in his capital account,

*the partners’ interests in the partnership with respect to the portion of the allocation that lacks economic effect will be determined by comparing the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were*

---

liquidated immediately following the end of the taxable year to which the allocation relates with the manner in which distributions (and contributions) would be made if all partnership property were sold at book value and the partnership were liquidated immediately following the end of the prior taxable year, and adjusting the result for the items described in (4), (5), and (6) of paragraph (b)(2)(ii)(d) of [Treasury Regulations Section 1.704-1]. A determination made under this paragraph (b)(3)(iii) will have no force if the economic effect of valid allocations made in the same manner is insubstantial under paragraph (b)(2)(ii) of this section.  

s. Illusion of Computational Regime.

Complex as this is, the after-tax filter of “substantiality” may sound better than it works in practice. Treasury Regulations describe what on its face appears to be a computational scheme. Treasury Regulations are sufficiently imprecise with what must be computed and how, that the computational scheme appears to be little more than a metaphysical model rather than something that some bright professional is supposed to dump into a computer and to have a precise answer on “substantiality” suddenly pop out like toast from a toaster. Close review of the after-tax filter of “substantiality” encourages the conclusion that no one writing Treasury Regulations ever attempted to apply “substantiality” as a precise mathematical test – or even thought all that much about how anyone else should apply “substantiality” as a precise mathematical test.

t. After-Tax Effects.

The determination of the after-tax economic consequences of the allocation (or allocations) to a partner is a non-trivial task. This requires some sort of forward projection of future partnership operations indefinitely into the future. Project not only partnership operations, but also the after-tax effects of these operations and the allocation on the partner. This calculus takes into account the complete tax situation of the partner. Determining the complete tax situation of the partner over the indefinite future is a considerable task. Obtaining the required information from partners may be an appreciable task. Partners may be reluctant to share confidential tax information with the partnership.

Reduce the projected future after-tax effects of the allocation to present value terms. This requires the use of a discount rate and some sort of convention for discounting future cash flows.

---

u. Discount Rate.

A vast literature in the areas of economics and finance considers the theory of what discount rate should be used to discount future cash flows. Do not immediately jump to the assumption that the correct discount rate is some talismanic rate (for example, the Applicable Federal Rate). Perhaps several different discount rates should be used for discounting future cash flows – perhaps one rate to discount short-term cash flows, another rate to discount intermediate-term cash flows, and a third rate to discount long-term cash flows. The discount rate perhaps should reflect the volatility or risk of the future cash flows. A higher discount rate might be used to discount more volatile or risky cash flows than those that are more dependably predictable. A high discount rate might be justified when future cash flows are highly volatile.

Even if you conclude that the analysis should use a particular discount rate (for example, the Applicable Federal Rate), determine whether this should be a short-term, mid-term, or long-term rate – or perhaps all three depending on the period for which you are discounting.

As you wish the computations to become more precise, consider the precise discounting formula, computational year, compounding, compounding dates, etc.

How the future projections should consider prospects for future changes in the tax laws – or the possible expiration of sunsetting tax provisions – could test the most prescient advisor. An iron rule that based all projections on current tax law might permit a set of tax allocations that would become abusive when measured against likely changes in the tax laws.

v. Projections.

Knowing how to project the economic future of the partnership’s investment – cash flow, income and loss – is difficult. The future of a real estate investment will depend on market conditions, interest rates, tenant turnover, bankruptcies, occupancy rates, repair costs, capital improvements, and even earthquakes, fires, and floods. The future performance of a real estate investment is not deterministic from the time of investment. Reasonable advisors can differ on future projections. A single advisor might suggest high, medium and low projections. Treasury Regulations are written as if the future is deterministic and perfectly known at the point at which the allocations are made. Treasury Regulations do not provide guidance concerning how to address the uncertainties of the world.

Present value computations are sensitive to the dates on which cash flows are realized. Taxpayers may pay a substantial portion of their tax liabilities through estimated tax payments or through wage withholding. Treasury Regula-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

tions do not address when tax liabilities are treated as paid or tax savings are
treated as realized.

Treasury Regulations require us to determine the present value of the af-fter-tax results with the allocation and without the allocation. This computation
considers the partner’s other tax items independent of the partnership. The tax-
payer’s other tax items and their interaction with partnership items must usually
be as difficult to project (and perhaps just as uncertain) as the future performance
of the partnership.

After you have determined (i) the after-tax economic consequences (in
present value terms) of some partner that may be enhanced, you need to compare
them to (ii) the after-tax consequences (in present value terms) to the partner if
the allocation were not contained in the partnership agreement. 1120 This requires
determining the after-tax consequences (in present value terms) to the partner if
the allocation were not contained in the partnership agreement. This requires de-
termining the result if “the allocation or allocations were allocated among the
partners in accordance with the partners’ interests in the partnership.” This sug-
gests that, to determine the “substantiality” of any allocation, you must first de-
terminate the result under “the partners’ interests in the partnership.” This determi-
nation can be quite a major task in itself, assuming in the first place that you can
obtain all of the necessary information from partners.

The after-tax filter of “substantiality” depends on establishing a strong
likelihood that (i) the after-tax economic consequences of no partner will (in pre-
sent value terms) be substantially diminished compared to (ii) the after-tax eco-
nomic consequences if the allocation or allocations were allocated among the
partners in accordance with the partners’ interests in the partnership. 1121 Both
“strong likelihood” and “substantially diminished” are ambiguous terms. A
“strong likelihood” presumably means substantially more than a 50% probability.
It is more than “likelihood.” The precise probability of “strong likelihood” is un-
resolved. A large dollar loss must result for economic consequences to be “su-
stantially diminished.” A reasonable case can be made that a small allocation that
benefits a partner cannot satisfy the after-tax filter, since –

at the time the allocation (or allocations) becomes part of the partnership
agreement, the after-tax economic consequences of at least one partner
may, in present value terms, be enhanced compared to such consequences
if the allocation (or allocations) were not contained in the partnership
agreement (and, thus, the allocation or allocations were allocated among

1121 Id.
the partners in accordance with the partners' interests in the partnership), and there is a strong likelihood that the after-tax economic consequences partnership), and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement (and, thus, the allocation or allocations were allocated among the partners in accordance with the partners' interests in the partnership).\textsuperscript{1122}

The first part of the after-tax filter of “substantiality” does not say anything about “strong likelihood” or about “substantially” better. The first of the after-tax filters requires that the “after-tax economic consequences of at least one partner may, in present value terms, be enhanced . . . .”\textsuperscript{1123} The first part of the after-tax filter does not require a “strong likelihood” that the after-tax economic consequences be enhanced. The first part of the after-tax filter does not require that the consequences be “substantially” enhanced. This makes it easy to satisfy the first part of the after-tax filter. The second half of the after-tax filter requires that “there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished . . . .” The second half of the filter appears more difficult to establish.

One might ask whether the after-tax filter of “substantiality” makes much sense at all. The after-tax filter of “substantiality” may have such a fine mesh that it traps too many special allocations to serve a useful tax purpose. An allocation normally will be undertaken only because someone thinks that the allocation is in his economic interest (on an after-tax basis): that his economic circumstances will be improved on an expected present value basis. The allocation may possibly be unfavorable to another in some respects to the extent that the allocation is favorable to someone. You might imagine that the other party, if able to negotiate, would negotiate to protect its best interests. The other party presumably would seek to ensure that, on a present value expected value basis, the other party is no worse off on account of the favorable allocation. The second part of the after-tax filter of “substantiality” almost assumes that some other partner cannot protect its best interests through negotiation or is oblivious to those interests. The requirement that “there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement” does not clearly make any sense. This should almost al-

\textsuperscript{1122} Id.
\textsuperscript{1123} Id.
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ways be the case with a negotiated special allocation, if the special allocation differs from the result of partners’ interests in the partnership.

Practically any special allocation (that differs from the result under partners’ interest in the partnership) should satisfy the requirement that “(1) the after-tax economic consequences of at least one partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained 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 such consequences if the allocation (or allocations) were not contained in the partnership agreement.”

The partner receiving the special allocation presumably would not want to agree to the special allocation unless “the after-tax economic consequences of [that] partner may, in present value terms, be enhanced compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.” This partner otherwise would not negotiate for the special allocation. We can be skeptical that, under normal circumstances, any partner would agree to the special allocation if “there is a strong likelihood that the after-tax economic consequences of [that] partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement.” Why would the other partner agree to the special allocation if “there is a strong likelihood that the after-tax economic consequences of [that] partner will, in present value terms, be substantially diminished compared to such consequences if the allocation (or allocations) were not contained in the partnership agreement”?

As a point of mathematical nuance, it is possible that the other partner who potentially suffers on account of the allocation may recognize that a strong likelihood exists that he will suffer on account of the allocation, but on an expected value basis the allocation of not unfavorable to this partner. This merely is a mathematical nuance.

w. Baseline for Comparison.

The preamble to 2008 revisions to the Treasury regulations contain this explanation of the substantiality baseline:

B. The Baseline for Comparison in § 1.704-1(b)(2)(iii)

Section 1.704-1(b)(2)(iii)(a) provides that the economic effect of an allocation is not substantial if, at the time the allocation becomes part of the partnership agreement, the after-tax economic consequences of at

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

least one partner may, in present value terms, be enhanced compared to such consequences if the allocation were not contained in the partnership agreement, and there is a strong likelihood that the after-tax economic consequences of no partner will, in present value terms, be substantially diminished compared to such consequences if the allocation were not contained in the partnership agreement. Because taxpayers have suggested that the baseline comparison required by this provision is unclear, the proposed regulations clarified this rule, consistent with the provisions of §1.704-1(b)(1)(i), by explaining that the after-tax economic consequences that result from the allocation must be compared to such consequences that would result if the allocations were not contained in the partnership agreement and were determined in accordance with the partners' interests in the partnership.

One comment suggested that an inconsistency existed between identifying the partners' interests in the partnership as the baseline for comparison in §1.704-1(b)(2)(iii)(a)(1) and (2) and the conclusions reached by §1.704-1(b)(5) Example 5. According to this comment, paragraph (ii) of §1.704-1(b)(5) Example 5 provides that the sharing percentages under the partners' interests in the partnership standard was 36 percent for one partner and 64 percent for the other partner. Comparing the after-tax economic consequences of the allocations contained in the partnership agreement with the 36/64 sharing percentages results in the after-tax economic consequences of one partner being enhanced and those of the other partner being substantially diminished. Thus, according to the comment, the conclusion in paragraph (i) of §1.704-1(b)(5) Example 5 cannot be correct. The after-tax test, however, is applied by comparing the allocations contained in the partnership agreement with the consequences determined in accordance with the partners' interests in the partnership had the allocations not been part of the partnership agreement. In Example 5, aside from the allocations being tested, the partners shared all other items equally and made equal capital contributions. To apply the substantiality test to the special allocations in that example, the results were compared to what would have occurred if the partners had 50/50 sharing percentages. This comparison revealed that one partner's after-tax economic return was enhanced and no partner's after-tax return was substantially diminished. Thus, the specially allocated items had to be reallocated under the partners' interests in the partnership. Under the facts of Example 5, the partners' interests in the partnership were the 36/64 sharing percentages, which were the same percentages in which they actually shared the partnership's total income for the year. The reallocation did not change the percentages in which the partners shared total income, but rather, required that each item of income (that is, tax-exempt income and
taxable interest and dividends included in total income) be shared in those same percentages. Thus, in Example 5 the partners’ interests in the partnership for purposes of reallocating the items that lacked substantial economic effect was determined to be different than the partners’ interests in the partnership used to test substantiality.

One comment suggested that the comparison to the partners’ interests in the partnership is equally applicable when testing shifting and transitory allocations under § 1.704-1(b)(2)(iii)(b) and (c) as it is to the after-tax test under § 1.704-1(b)(2)(iii)(a), and suggested that the final regulations so provide. This comment is adopted and, in order to further clarify that the partners’ interests in the partnership (determined without regard to the allocation or allocations being tested) is the baseline for comparison when testing the substantiality of an allocation, whether under the after-tax test or the shifting or transitory allocation test, the final regulations remove the parenthetical clauses inserted by the proposed regulations and add a sentence to the end of § 1.704-1(b)(2)(iii)(a)(1) that provides that references in § 1.704-1(b)(2)(iii) to an allocation (or allocations) not contained in the partnership agreement mean that the allocation (or allocations) is determined in accordance with the partners’ interests in the partnership (within the meaning of paragraph § 1.704-1(b)(3)), disregarding the allocation (or allocations) being tested under § 1.704-1(b)(2)(iii).\(^{1125}\)

x. **Per Capita Presumption.**

The per capital allocation presumption was removed in 2008. This explanation is from the preamble to the amendment:

**C. Removal of Per Capita Presumption in § 1.704-1(b)(3)**

The proposed regulations removed the per capita presumption in § 1.704-1(b)(3). Because this section generally does not contain mechanical rules to determine the partners’ interests in the partnership, one comment suggested that the presumption was necessary to reduce complexity, and therefore recommended that the final regulations reinsert the presumption. However, because the per capita presumption failed to consider factors relevant to a determination of the manner in which the partners agreed to share the economic benefits or burdens corresponding to the allocation of partnership items, the correct result was reached in very few cases. Accordingly, the Treasury Department and IRS believe that any

---

benefits of the presumption are outweighed by the potential for incorrect
determinations.\textsuperscript{1126}

y. Pass-Through Entities.

The Treasury Regulations next turn to the question of pass-through enti-
ties – an issue ignored by prior final Treasury Regulations. Advisors previously
were at a loss to know how to determine after-tax consequences to partners when
whose partners were pass-through entities that did not pay tax, but rather pass
through the taxable income to taxable partners at a higher level. Prior final Treas-
ury Regulations, applied literally, would determine the after-tax analysis of the
after-tax filter of “substantiality” at the partner level. This does not make much
sense when the partner is a pass-through entity. This defect in prior final Treasury
Regulations was an invitation to abuse.

You could imagine a number of entities that might qualify as pass-through
entities. They would include partnerships and S corporations. Pass-through enti-
ties might include controlled foreign corporations, regulated investment compa-
nies, real estate investment trusts, and many trusts. The Treasury Regulations treat
these entities as pass-through entities for purposes of determining “substantiali-
y” –

- A partnership;
- A subchapter S corporation;
- A trust;
- An entity that is disregarded for Federal tax purposes (for example,
a qualified subchapter S subsidiary under section 1361(b)(3)), an
entity that is disregarded as an entity separate from its owner under
Treasury Regulations Sections 301.7701-1 through 301.7701-3, or
a qualified REIT subsidiary (Section 856(i)(2)).
- A controlled foreign corporation (Section 957(a)), but only with
respect to allocations of items of income, gain, loss, or deduction
that enter into the corporation’s computation of subpart F income
or would enter into that computation if the items were allocated to
the corporation (collectively, subpart F items).\textsuperscript{1127}

The Treasury Regulations provide a special rule for determining the after-
tax economic benefit or detriment to any partner that is a look-through entity. The
tax consequences that result from the interaction of the allocation with the tax at-
tributes of any person that owns an interest in the partner must be taken into ac-
count. This applies regardless of whether the ownership in the partner is direct or indirect or through one or more look-through entities. The Treasury Regulations apply the after-tax filter of “substantiality” to pass-through entities by looking through those entities until they reach taxpaying (or, at least, tax-respected) partners. Obtaining this current and future tax information from indirect partners may pose a difficult task for the partnership.

The preamble to Treasury Decision 9398 clarifies that:

The proposed regulations clarify several aspects of the regulations under section 704. The proposed regulations generally provide a “look-through rule” for purposes of testing the substantiality of an allocation. The proposed regulations provide that in determining the after-tax economic benefit or detriment of a partnership allocation to any partner that is a look-through entity, the look-through rule takes into account the tax consequences that result from the interaction of the allocation with the tax attributes of any owner of the look-through entity. Similarly, in determining the after-tax economic benefit or detriment to any partner that is a member of a consolidated group, the proposed regulations generally provide that the tax consequences that result from the interaction of the allocation with the tax attributes of the consolidated group and with the tax attributes of another member with respect to a separate return year must be taken into account. The proposed regulations provide that a look-through entity means a partnership, subchapter S corporation, trust, an entity disregarded for Federal tax purposes, or certain controlled foreign corporations (CFCs).

The proposed regulations clarify that, for purposes of § 1.704-1(b)(2)(iii)(a), the after-tax economic consequences of an allocation contained in the partnership agreement was compared to the after-tax economic consequences of the allocation made in accordance with the partners’ interest in the partnership (within the meaning of § 1.704-1(b)(3)). For that purpose, the partners’ interest in the partnership was determined as if the allocations tested were not contained in the partnership agreement. Also, the proposed regulations remove the per capita presumption in § 1.704-1(b)(3)(i). Finally, the proposed regulations include an example illustrating one circumstance where a provision other than section 704(b) may be used to reallocate partnership items.

The look-through rule is well-intentioned and theoretically sound. The look-through rule is impractical in a broad range of circumstances—especially when a partnership has a large number of partners. The after-tax filter of “substantiality” is difficult to apply to the simplest partnership situation. The after-tax filter requires forward projections of partner after-tax effects, considering each partner’s partnership and nonpartnership items. The look-through entity rule poten-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

tially expands the number of computations that must be made to apply the after-tax filter of “substantiality.” This can increase the practical difficulty of applying the after-tax filter of “substantiality” by increasing the number of partners for whom projections and computations must be made.

A controversial issue under the Treasury Regulations is whether real estate investment trusts and regulated investment companies should be considered “look-through entities, so that “substantiality” considers tax effects on investors in the real estate investment trust and regulated investment company. Treasury has asked for comments concerning the potential application of the after-tax filter of “substantiality” to these entities. The resolution of this issue will have to balance questions of theoretical imperative and questions of practicality and administrability.

Real estate investment trusts and regulated investment companies often purge themselves of their tax liabilities – or, at least, most of their tax liability – by making distributions to shareholders and claiming dividend-received deductions. A real estate investment trust, for example, might be substantially all owned by tax-exempt parties. A partnership could make an income allocation to the real estate investment trust. The real estate investment trust could purge itself of tax liability by making dividend distributions to tax-exempt shareholders. No tax would be paid on account of the income allocation. The real estate investment trust in effect would be a tax indifferent party. The real estate investment trust does not necessarily have to make distributions beyond those necessary to preserve qualification. The real estate investment trust might bear tax on an allocation itself. One could question how “substantiality” could treat real estate investment trusts and regulated investment companies as look-through entities in a world of finite accounting resources and imperfect information on future tax attributes of the shareholders. Treating real estate investment trusts and regulated investment companies as look-through entities often makes theoretical sense when they distribute partnership income; however, it is doubtful that the after-tax filter of “substantiality” can be applied to real estate investment trusts and regulated investment companies on a true look-through basis on account of the vast extent of the projections and computations that would be required. A theoretically accurate model of real estate investment trusts and regulated investment companies must project the extent to which the entity will distribute its earnings as part of the model. Obtaining sufficient tax information concerning real estate investment trust or regulated investment company shareholders, both on a current and go-forward basis, could prove an insuperable task for the partnership – and likely would tax the resources of the IRS.

Two special rules of substantiality are found in Treasury Regulations. One rule addresses shifting tax consequences. Another rule addresses transitory allocations. The first rule prohibits allocations designed to shift tax consequences but
without economic shifts between the partners. The second rule prohibits transitory allocations that are reversed with offsetting allocations.

z. **Shifting tax consequences.**

The shifting tax consequences test imposes an annual test of partnership allocations. The economic effect of an allocation (or allocations) in a partnership taxable year is not substantial if (at the time the allocation (or allocations) becomes part of the partnership agreement) a strong likelihood exists that –

- The net increases and decreases that will be recorded in the partners’ respective capital accounts for the taxable year will not differ substantially from
  - the net increases and decreases that would be recorded in the partners’ respective capital accounts for the partnership’s taxable year if the allocations were not contained in the partnership agreement,\(^{1128}\) and

- The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if –
  - the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership).\(^{1129}\)

The “value equals basis” rule should operate in making determinations under this test.

Any reduction in tax is sufficient to satisfy this test. The test does not expressly require that the reduction in total tax liability will be material.

This example from Treasury Regulations is supposed to illustrate “substantiality”:

**Example (6).** K and L are equal partners in a general partnership formed to acquire and operate property described in section 1231(b). The partnership, K, and L have calendar taxable years. The partnership agreement provides that the partners’ capital accounts will be determined and maintained in accordance with paragraph (b)(2)(iv) of this section, that distributions in liquidation of the partnership (or any partner’s inter-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

est) will be made in accordance with the partners’ positive capital account balances, and that any partner with a deficit balance in his capital account following the liquidation of his interest must restore that deficit to the partnership (as set forth in paragraphs (b)(2)(ii)(b)(2) and (3) of this section). For a taxable year in which the partnership expects to incur a loss on the sale of a portion of such property, the partnership agreement is amended (at the beginning of the taxable year) to allocate such loss to K, who expects to have no gains from the sale of depreciable property described in section 1231(b) in that taxable year, and to allocate an equivalent amount of partnership loss and deduction for that year of a different character to L, who expects to have such gains. Any partnership loss and deduction in excess of these allocations will be allocated equally between K and L. The amendment is effective only for that taxable year. At the time the partnership agreement is amended, there is a strong likelihood that the partnership will incur deduction or loss in the taxable year other than loss from the sale of property described in section 1231(b) in an amount that will substantially equal or exceed the expected amount of the section 1231(b) loss. The allocations in such taxable year have economic effect. However, the economic effect of the allocations is insubstantial under the test described in paragraph (b)(2)(iii)(b) of this section because there is a strong likelihood, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K’s and L’s capital accounts will be the same at the end of the taxable year to which they apply with such allocations in effect as they would have been in the absence of such allocations, and that the total taxes of K and L for such year will be reduced as a result of such allocations. If in fact the partnership incurs deduction or loss, other than loss from the sale of property described in section 1231(b), in an amount at least equal to the section 1231(b) loss, the loss and deduction in such taxable year will be reallocated equally between K and L under paragraph (b)(3) of this section. If not, the loss from the sale of property described in section 1231(b) and the items of deduction and other loss realized in such year will be reallocated between K and L in proportion to the net decreases in their capital accounts due to the allocation of such items under the partnership agreement.\footnote{1130}{Treas. Reg. § 1.704-1(b)(5), Example (6).}

This is an egregious case of exploitation of a limited tax opportunity and a shirting allocation. At the time when the partnership agreement is amended, a strong likelihood exists that the partnership will incur deduction or loss in the taxable year other than loss from the sale of property described in Section 1231(b) in
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

an amount that will substantially equal or exceed the expected amount of the Section 1231(b) loss. The example does not explain what a “strong likelihood” means. The example does not explore how this “strong likelihood” is determined. “Strong likelihood” in the example is just assumed in the script. The assumptions of the example make it easy to determine that a strong likelihood exists, at the time the allocations become part of the partnership agreement, that the net increases and decreases to K’s and L’s capital accounts will be the same at the end of the taxable year to which they apply with the allocations in effect as they would have been in the absence of the allocations. The facts of the example make it easy to assume that the total taxes of K and L for the partnership’s taxable year will be reduced as a result of the allocations.

The shifting tax consequences test is an annual test. The shifting tax consequences test is a two part test. An allocation must fail two subtests in order to be disallowed under the shifting tax consequences test. The shifting tax consequences test may be applied to an individual allocation or to a group of allocations. The allocation fails substantiality if the allocation fails the shifting tax consequences test. Any allocation failing substantiality will cause all allocations not to have substantial economic effect. The partnership agreement and all of its allocations are tainted if an allocation fails the shifting tax consequences test.

The shifting tax consequences test suggests that it is a test of tax gimmickry and manipulation in the partnership agreement. Someone has changed the natural allocations. The allocations contained in the partnership agreement improve the tax deal but do not have a material effect on the economic deal.

A base deal exists. An honest, pure baseline exists. Someone has gimmicked the base deal in an offensive manner in order to produce distorted and unrealistic tax results. Some bright tax planner has manipulated allocations (in some knowable manner) to improve tax results.

The shifting tax consequences test depends on “strong likelihood.” This suggests something that is discrete and knowable. You might test the waters with some sort of tax abuse thermometer to assess some probability of abusive results – improved tax results but no material change in economics. The allocation fails if the chances of a manipulative result is x,y% or greater if “strong likelihood” translates into x,y%. The allocation will not be disallowed under the shifting tax consequences test if the chance of a manipulative result is less than x,y%. You need to have the finesse and insight to compute the quantitative chances of a manipulative result.

A “strong likelihood” of manipulation must exist. This suggests that the probability of manipulation must be considerably more than 50%. That would be “likelihood.” A “strong likelihood” must exist. This presumably suggests some
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

probability (x.y%) that is substantially greater than 50% to reach “strong likelihood.”

The Treasury Regulations in effect suggest a tax manipulation thermometer as an index of tax manipulation. That thermometer could register a well-defined probability of manipulation. That probability of manipulation must exceed some discrete threshold (x.y%), but you do not quite know what that “strong likelihood” threshold really is. Assuming that is makes sense to speak in terms of probability of manipulation, that this is a measurable phenomenon, the threshold presumably should be some percentage (x.y%) that is discernable, precise, and invariable. Treasury Regulations do not share with us what that threshold percentage is. You might object that Treasury Regulations would have done a better job if they had set forth a clearer numerical percentage rather than used the more subjective “strong likelihood.”

i) Capital Account Test.

The first part of the shifting tax consequences test (capital account test) compares

- the net increases and decreases that will be recorded in the partners’ capital accounts for the taxable year with the tested allocation or allocations to
- the net increases and decreases that would be recorded in the partners’ capital accounts for the partnership’s taxable year if the allocations were not contained in the partnership agreement.

The first part of the shifting tax consequences test asks if (at the time the allocation (or allocations) becomes part of the partnership agreement) a strong likelihood exists that –

- (i) the net increases and decreases that will be recorded in the partners’ respective capital accounts for the taxable year will not differ substantially from
- (ii) the net increases and decreases that would be recorded in the partners’ respective capital accounts for the partnership’s taxable year if the allocations were not contained in the partnership agreement.

The capital account test under the shifting tax consequences test is applied year by year and examines (i) and (ii) calculated only for the current year.

The baseline in the first part of the shifting tax consequences test (the capital account portion of the test) is the net increases and decreases that would have been recorded in the partners’ respective capital accounts for the partnership’s taxable year if the allocations were not contained in the partnership agree-
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

ment. You need to know what the capital accounts would have been if no manipu-
lation had been undertaken. This baseline presumably is dependent only on real-
locating items in the manner in which the items would have been allocated if the
special allocations were not contained in the partnership agreement. This suggests
an analytical paradigm that, if you were to eliminate the allocation or allocations,
you can establish what the partnership agreement would have looked like and how
it would have made allocations. That may be a matter of some speculation in ap-
propriate circumstances. Someone could object that this may import more than
striking special allocations and including specially allocated items in bottom line
net profits and net losses. You perhaps do not know what would have happened if
the special allocations had not been made. Perhaps a partner would have required
a higher preferred return or a larger percentage interest or a guaranteed payment.
Perhaps the deal would have changed entirely if the special allocation had not
been included in the partnership agreement.

This inquiry gives the partnership and the IRS much about which to talk. You
may not know precisely what would have been the net increases and de-
creases that would be recorded in the partners’ respective capital accounts for the
partnership’s taxable year if the allocations were not contained in the partnership
agreement. You may have only supposition. You may have an array of different
suppositions of what capital accounts would have been if the allocations were not
contained in the partnership agreement.

ii) Tax Consequences Test.

The second part of the shifting tax consequences test (tax consequences
test) asks if (at the time the allocation (or allocations) becomes part of the partner-
ship agreement) a strong likelihood exists that – (i) the total tax liability of the
partners with the tested allocation or allocations (for their respective taxable years
in which the allocations will be taken into account) will be less than if (ii) the al-
locations were not contained in the partnership agreement (taking into account tax
consequences that result from the interaction of the allocation (or allocations)
with partner tax attributes that are unrelated to the partnership). The test requires
some reduction in total tax liability. The test does not explicitly require that this
reduction be material.

The tax consequences test forces the partnership first to compute the total
tax liability of the partners with the tested allocation or allocations (for their re-
spective taxable years in which the allocations will be taken into account). The
partnership next must compute the total tax liability of the partners (for their re-
spective taxable years in which the allocations will be taken into account) as if the
allocations were not contained in the partnership agreement. This requires some
speculation on how the partnership agreement would be drafted if the tested allo-
cations were not contained in the partnership agreement. This computation is not
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

adjusted for present values. The partnership must ask whether a strong likelihood
(whatever that means) exists that (i) will be less than (ii).

The tax consequences test requires considerably more computing than the
capital account test requires. The capital account test considers only changes in
capital account adjustments for the current year of the allocation. The tax conse-
quences test requires computations for every year in which allocations will be
made under the allocation or allocations that is being tested. The tax consequenc-
es test requires computing the total tax liability of the partners for all of their re-
spective taxable years in which the allocations will be taken into account. This
computation does not pay attention to the partnership’s taxable year in which tax
liabilities are incurred. Tax liabilities for the various years in which the alloc-
a tions are expected to be made are computed and added together. This requires
making pro forma tax return computations for all partners for all years in which
an allocation is expected. The numbers are not present value adjusted.

The problem of the tax consequences test is that it is one thing to talk
about (i) the total tax liability of the partners with the allocation or allocations (for
their respective taxable years in which the allocations will be taken into account)
and (ii) the total tax liability of the partners (for their respective taxable years in
which the allocations will be taken into account) if the allocations were not con-
tained in the partnership agreement (taking into account tax consequences that
result from the interaction of the allocation (or allocations) with partner tax attrib-
utes that are unrelated to the partnership), and quite another matter to compute
these total tax liabilities. The computation is difficult enough if you are just com-
puting (i) for the current taxable year. Compute these liabilities with the alloca-
tion indefinitely into the future, making sure to pay proper attention to tax conse-
quences that result from the interaction of the allocation (or allocations) with
partner tax attributes that are unrelated to the partnership. You need perfect in-
formation concerning the indefinite future to make these computations perfectly.
Partnership case law, statutory law and administrative law do not provide a clear
mechanism for the partnership to seek current numbers from the partners, let
alone projections for the future, let alone projections of other partner tax attributes
that are unrelated to the partnership. The task can be generally described as a ma-
ter of theory, but it is rather impractical as a matter of practice. At best, one can
hope for rather vague short-term estimates that may be useful only in the most
extreme case.

The tax consequences test next requires computing the total tax liability of
the partners (for their respective taxable years in which the allocations will be
taken into account) if the allocations were not contained in the partnership agree-
ment. The starting point is to determine how the partnership agreement would
work in the absence of the special allocation or allocations. This often is a matter
of speculation. This computation takes into account tax consequences that result
from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership. One can imagine engaging a crystal ball gaz-er to determine all of these numbers. Ordinary tax advisors may be less useful. The computations do not take present value concepts into account. Accurate projections require perfect knowledge concerning future tax consequences to all of the partners and perfect knowledge of the partnership’s future tax items. The tax consequences to the partners will depend on the interaction of these future tax items with other tax items in the partners’ personal returns. This computation looks through flow-through entities to the tax paying owners. The computation possibly can be affected by expected future changes in tax law. As the number of partners increases, the computational task becomes unwieldy. One can imagine how expensive all of this projecting and computing could become. Little time or financial recourses may be left to devote to the success of the partnership.

iii) Presumption Concerning Shifting Tax Consequences.

Treasury Regulations contain a presumption regarding shifting tax conse-quences. The rule concerning shifting tax consequences generally presumes that there are offsetting results if (at the end of the partnership’s taxable year of an allocation) adjustments to capital account are not substantially different with the allocation than they would be without the allocation, and the total tax liability is lowered by the inclusion of the allocations. Treasury Regulations presume that there was a strong likelihood that offsetting results would occur if (at the end of a partnership taxable year to which an allocation (or allocations) relates) –

- the net increases and decreases that are recorded in the partners’ respective capital accounts do not differ substantially from –
  - the net increases and decreases that would have been re-coded in the partners’ respective capital accounts had the allocation (or allocations) not been contained in the partnership agreement, and

- the total tax liability of the partners is less than it would have been had the allocation (or allocations) not been contained in the partnership agreement.\textsuperscript{1131}

The presumption does not require a large reduction in tax liability. The presumption can be triggered by a small reduction in tax liability.

The presumption concerning shifting tax consequences may be overcome by a showing of facts and circumstances that prove otherwise. The partnership itself may have no idea that the total tax liability of the partners is less than it

\textsuperscript{1131}Treas. Reg. § 1.704-1(b)(2)(iii)(b).
would have been had the allocation (or allocations) not been contained in the partnership agreement. The partnership may not have access to partner tax information. The partnership does not necessarily have a means of recovering this partner based information.

**aa. Transitory Allocations.**

The rule concerning transitory allocations provides generally that if a strong likelihood exists that offsetting allocations will create offsetting adjustments to capital account and the tax liability is reduced by the allocations, the economic effect of the offsetting allocations is not substantial. If –

- A partnership agreement creates the possibility that one or more allocations (the “original allocations”) will be largely offset by one or more other allocations (the “offsetting allocations”), and,
- At the time the allocations become part of the partnership agreement, a strong likelihood exists that—
  - The net increases and decreases that will be recorded in the partners’ respective capital accounts for the taxable years to which the allocations relate will not differ substantially from
  - the net increases and decreases that would be recorded in the partners’ respective capital accounts for the partnership’s taxable years if the original allocations and offsetting allocations were not contained in the partnership agreement,\(^{1132}\) and
- The total tax liability of the partners (for their respective taxable years in which the allocations will be taken into account) will be less than if the allocations were not contained in the partnership agreement (taking into account tax consequences that result from the interaction of the allocation (or allocations) with partner tax attributes that are unrelated to the partnership),\(^{1133}\) the economic effect of the original allocations and offsetting allocations will not be substantial. This test is qualified by the “value equals basis” rule: the value of property is presumed to decline in accordance with “book” depreciation.

If, at the end of a partnership taxable year to which an offsetting allocations relates,

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- The net increases and decreases recorded in the partners’ respective capital accounts do not differ substantially from
- The net increases and decreases that would have been recorded in the partners’ respective capital accounts had the original allocations and the offsetting allocations not been contained in the partnership agreement, and
- The total tax liability of the partners is less than it would have been had the allocations not been contained in the partnership agreement,

it will be presumed that (at the time the allocations became part of the partnership agreement) there was a strong likelihood that these results would occur.\(^{1134}\)

This presumption may be overcome by a showing of facts and circumstances that prove otherwise.

This formulation of the transitory allocation presumption\(^{1135}\) suffers from the characteristic infirmities of the substantiality rules. You do not know precisely what it means for the net increases and decreases recorded in the partners’ respective capital accounts not to differ substantially from the net increases and decreases that would have been recorded in the partners’ respective capital accounts had the original allocations and the offsetting allocations not been contained in the partnership agreement. You do not necessarily know what net increases and decreases would have been recorded in the partners’ capital accounts had the original allocations and the offsetting allocations not been contained in the partnership agreement. You do not necessarily know what the partnership world would look like had the original allocations and the offsetting allocations not been contained in the partnership agreement. You may have imperfect information in determining the total tax liability of the partners either with or without the allocation. You may have poor information concerning partnership projections. You may have difficulty projecting the interaction with other partner items. You may not receive cooperation from the various partners in computing the total tax liability of the partners either with or without the allocation.

bb. Five-Year Presumption.

Notwithstanding the foregoing rule, the original allocations and the offsetting allocations will not be insubstantial and it will be presumed that a reasonable possibility exists that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if (at the time the allocations be-

\(^{1134}\) Treas. Reg. § 1.704-1(b)(2)(iii)(b).
\(^{1135}\) Treas. Reg. § 1.704-1(b)(2)(iii)(c).
come part of the partnership agreement) a strong likelihood exists that the offsetting allocations will not, in large part, be made within five years after the original allocation is made (determined on a first-in, first-out basis).

The “value equals basis” rule applies for purposes of these substantiality computations. The adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of the property) will be presumed to be the fair market value of the property, and adjustments to the adjusted tax basis (or book value) of the property will be presumed to be matched by corresponding changes in the property’s fair market value. A strong likelihood cannot exist that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property.

The creativity of tax planners suggests that the filter of economic effect will not be enough, standing alone, to prevent abusive allocations that are not consistent with true partnership economics. The purpose of the “substantiality” is to discern business-motivated special allocations from tax-motivated special allo-

---

1136 Treas. Reg. § 1.6664-4(f) (“This presumption may be overcome by a showing of facts and circumstances that prove otherwise. See examples (1)(xi), (2), (3), (7), (8)(ii), and (17) of paragraph (b)(5) of this section. Notwithstanding the foregoing, the original allocation(s) and the offsetting allocation(s) will not be insubstantial (under this paragraph (b)(2)(iii)(c)) and, for purposes of paragraph (b)(2)(iii)(a), it will be presumed that there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners from the partnership if, at the time the allocations become part of the partnership agreement, there is a strong likelihood that the offsetting allocation(s) will not, in large part, be made within five years after the original allocation(s) is made (determined on a first-in, first-out basis). See example (2) of paragraph (b)(5) of this section. For purposes of applying the provisions of this paragraph (b)(2)(iii) (and paragraphs (b)(2)(ii)(d)(6) and (b)(3)(ii) of this section), the adjusted tax basis of partnership property (or, if partnership property is properly reflected on the books of the partnership at a book value that differs from its adjusted tax basis, the book value of such property) will be presumed to be the fair market value of such property, and adjustments to the adjusted tax basis (or book value) of such property will be presumed to be matched by corresponding changes in such property’s fair market value. Thus, there cannot be a strong likelihood that the economic effect of an allocation (or allocations) will be largely offset by an allocation (or allocations) of gain or loss from the disposition of partnership property. See examples (1) (vi) and (xi) of paragraph (b)(5) of this section.”).

1137 The creativity of tax planners suggests that the filter of economic effect will not be enough, standing alone, to prevent abusive allocations that are not consistent with true partnership economics. The purpose of the “substantiality” is to discern business-motivated special allocations from tax-motivated special allo-
143. Special Partner Considerations.

Section x.x. Actions to Preserve REIT Qualification.

(a) Notwithstanding any other provision of this Agreement or the Act, the Manager shall be entitled (in its sole and absolute discretion) to cause the Company to distribute sufficient amounts to enable the Manager to pay to its shareholder dividends that

(i) Will satisfy the requirements for qualification as a “real estate investment trust” under the Code and

(ii) Will minimize any federal income or excise tax liability of the Manager.

Special Partner Considerations. The IRS and Treasury apparently sought to develop an objective filter to make an inherently subjective inquiry. The filter of “substantiality” as described in the current Treasury Regulations fails to serve the role of providing a reliable filter capable of consistent application. The Proposed Treasury Regulations merely provide repairs, but do not salvage Treasury Regulations. The filter of “substantiality” is poorly developed and clumsy in both the current Final Treasury Regulations and the newly published Proposed Treasury Regulations. The rules of “substantiality” are not sufficiently detailed in the Proposed Treasury Regulations in order to be properly applied in the simplest situation. The rules break down badly when you take into account considerations (for example, the unpredictability of future cash flow, income, and loss; the unpredictability of partner’s nontax items; the unpredictability of future tax rates and other tax changes, and the unpredictability of future changes in economic interests in the partnership). “Substantiality” needs to be re-engineered in order to provide the IRS with a consistently useful filter. The IRS may not be able to develop an effective objective filter of “substantiality.” Experience has demonstrated that the filter of “substantiality” is a paper tiger that is substantially ignored by most partnership agreement draftsmen and by most auditing IRS agents.

Similarly, the “value equals basis” rule should be revisited by the IRS. The “value equals basis” rule makes sense to authorize special allocations of depreciation deductions and corresponding chargeback allocations. The “value equals basis” rule does not make sense when applied to allocating gain from sale when sale of property is imminent, when property is under contract, or when the sale may already have occurred. The scope of the presumption in the “value equals basis” rule should be carefully defined by the IRS. Rather than seek to reform the current mathematical filter of “substantiality,” the IRS would be as well to scrap the current filters and to come up with a more workable standard of “substantiality.”
(b) Any action of the Manager on behalf of the Company or any decision of the Manager to refrain from acting on behalf of the Company, undertaken in the good faith belief that the action or omission is necessary or advisable in order –

(i) To protect the ability of the Manager to continue to qualify as a “real estate investment trust” under the Code (under Part II of Subchapter M of Chapter I), or

(ii) To permit the Manager to minimize any taxes otherwise imposed on the Manager under Section 857 (taxation of real estate investment trusts) or Section 4981 (tax on undistributed income) of the Code,

is expressly authorized under this Agreement and is treated as approved by all of the Members.

This is more specific set of REIT restrictions:

Section x.x. REIT Compliance Restrictions. Unless the REIT Member consents otherwise:
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

(a) The Company shall cause the Property Owner to enter into all leases of the Property such that all rents from such leases constitute “rents from real property” for purposes of Section 856(d).

(b) If the Company or the Property Owner shall lease personal property in connection with a lease of real property, the rent attributable to such personal property for any taxable year shall not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

(c) The Company shall cause the Property Owner to enter into all leases of the Property such that no amount received or accrued, directly or indirectly, with respect to any real or personal property, shall be determined based in whole or in part on the income or profits derived by any person from such property; provided, however, rents may be based on a fixed percentage or percentages of receipts or sales.

(d) The Company shall cause the Property Owner not to lease to any portion of the Property to a person described in Section 856(d)(2)(B).

(e) The Company shall cause the Property Owner to enter into all leases of the Property such that none of the income of the Property Owner shall constitute “impermissible tenant service income” as defined in Section 856(d)(7).

(f) The Company shall cause the Property Owner to ensure that any services to tenants of the Property that would cause any rents from the Property to constitute “impermissible tenant service income” shall be performed through independent contractors (as defined in Section 856(d)(3)) or through a taxable REIT subsidiary of REIT (as defined in Section 856(l)).

(g) The Company shall not acquire directly or indirectly or by attribution under Section 856(d)(5) more than 10% of the total value of all classes of stock or more than 10% of the total voting power (or an interest of 10% or more in the assets or net profits) of any lessee or sublessee of all or any part of the Property.

(h) The Company shall not enter into (and the Company shall not permit the Property Owner to enter into) any transaction that shall constitute a “prohibited transaction” under Section 857(b)(6).

(i) The Company shall not own or acquire, directly or indirectly or by attribution, securities that represent more than 10% of the total voting power of the outstanding securities of any issuer or own any other
asset which would cause REIT Land Company to fail the asset test of Section 856(c)(4)(B).]

A REIT that is a general partner of a partnership often will require that the partnership agreement permit the REIT to consider special provisions to consider the REIT’s special tax considerations.

A real estate investment trust or a tax-exempt investor is a partner in your partnership may ask for a matrix of limitations and special provisions in your partnership agreement in order to address special tax interests of the entity. Both will want property rents to qualify as “rents from real property” under special tax rules. Both will look for prohibition of “dealer”-type activities (developing real property for sale in the ordinary course of a trade or business). Tax-exempt investors may look for provisions that will ensure that all allocations are “qualified allocations” in order to address special tax concerns of tax-exempt investors. Tax-exempt investors may look for restrictions on the ability of your partnership to acquire real estate with “acquisition indebtedness.” Tax-exempt partners may ask for additional limitations to ensure that the partnership does not produce unrelated business taxable income. Pension funds may ask for special provisions to address the “plan asset” rules under Employee Income Security Act of 1974. Some partners will insist that a partnership agreement contain detailed nondiscrimination provisions.

A tax-exempt partner might require a provision like this:

Section x.x. Tax-Exempt Investors.

(a) Any Tax-exempt Partner may exercise any vote, consent, election or other right under this Agreement with a view to avoiding (or minimizing) any “unrelated business taxable income” (within the meaning of Section 512(a) of the Internal Revenue Code (“UBTI”)) to the Tax-exempt Partner and without regard to whether conducting the business of the Partnership in this manner will maximize either pre-tax or after-tax profit of the Partnership to a Partner (or a direct or indirect investor in a Partner) that is not a Qualified Organization.

(b) The Partners shall not cause or permit the Partnership (without prior written consent of the Tax-exempt Partners) –

(i) To obtain financing from any seller to the Partnership of any property or any individual or entity who bears a relationship described in Internal Revenue Code Sections 267(b) or 707(b) to any such seller;

(ii) To lease any property to any seller or to any individual or entity who bears a relationship described in Internal Revenue Code Sections 267(b) or 707(b) to any such seller;
(iii) To obtain any financing if the amount of the indebtedness or any other amount payable with respect to the financing, or the time for making any payment, is dependent upon any revenue, income or profits derived from any property;

(iv) To incur any indebtedness that would constitute “partner nonrecourse debt” as defined in Treasury Regulations Section 1.704-2(b)(4);

(v) To enter into any lease that provides for contingent rental payments unless based upon the tenant’s gross receipts;

(vi) To enter into any lease or other arrangement under which it receives rents from personal property or payment for the performance of services that would constitute UBTI;

(vii) To invest in or to hold (directly or through one or more entities) any interest in any partnership (or any entity treated as a partnership for federal income tax purposes) if at any time that partnership does not comply with Internal Revenue Code Section 514(c)(9)(E);

(viii) To derive income from the sale, exchange, or other disposition of property held primarily for sale to customers in the ordinary course of trade or business; or

(ix) Otherwise to engage in any business or transaction that would result in the derivation of income by the Tax-exempt Partner from an “unrelated trade or business” (as defined in Internal Revenue Code Section 513).

144. Section 724: Contributions of Receivables and Inventory.

Yet another obscure tax provision can affect gain or loss associated with property contributed to your partnership by a partner. Internal Revenue Code Section 724 locks in the ordinary income character of unrealized receivables and inventory items. The lock-in period for unrealized receivables is permanent. The lock-in period for inventory items is five years. Section 724 says that loss recognized by a partnership with respect to contributed capital loss property will be locked in as a capital loss in your partnership’s hands. This lock-in lasts for five years. Consider including certain representations in your partnership to address the character of contributed assets.

In the case of any property which–

- Was contributed to the partnership by a partner, and
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Was an unrealized receivable in the hands of the partner immediately before the contribution, any gain or loss recognized by the partnership on the disposition of the property shall be treated as ordinary income or ordinary loss (as the case may be).

In the case of any property which:
- Was contributed to the partnership by a partner, and
- Was an inventory item in the hands of the partner immediately before the contribution, any gain or loss recognized by the partnership on the disposition of the property during the 5-year period beginning on the date of the contribution shall be treated as ordinary income or ordinary loss, as the case may be.

In the case of any property which:
- Was contributed by a partner to the partnership, and
- Was a capital asset in the hands of the partner immediately before the contribution, any loss recognized by the partnership on the disposition of the property during the 5-year period beginning on the date of the contribution is treated as a loss from the sale of a capital asset to the extent that (immediately before the contribution) the adjusted tax basis of the property in the hands of the partner exceeded the fair market value of the property.

Any property subject to Section 724 treatment disposed of in a nonrecognition transaction results in the tax treatment which applies to this contributed property under Section 724 applying to any substituted basis property resulting from the transaction. A similar rule applies in the case of a series of nonrecognition transactions.

145. Contributed Payables.

Accounts payable and other accrued but unpaid items contributed by a partner using the cash receipts and disbursements method of accounting are treated as contributed property with gain associated with a “book”-tax disparity (Section 704(c) property). The accounts payable of a cash-method partner that would give rise to a deduction when paid by the partner are not treated as liabilities. The deductions are allocated back to the contributing partner in accordance with principles for allocating loss associated with property with a “book”-tax disparity (Section 704(c)) when the accounts payables are paid by the partnership.
146. Intangibles.

Partnerships – even real estate partnerships – often receive contributions of intangible assets (including goodwill, trade names, etc.). The most important intangible contributed to a real estate partnership often is goodwill. Intangibles can include work force, operating systems, lists or other information with respect to current or prospective customers, designs, know-how, and licenses, permits, or other rights, franchises, trademarks, and trade names. The Code mandates special tax treatment for these assets. Section 197 permits partnerships and other taxpayers to amortize “amortizable Section 197 intangibles” held by the partnership in connection with the conduct of a trade or business or an activity engaged in for the production of income.\footnote{Treas. Reg. § 1.197-2(a)(1) (“Section 197 allows an amortization deduction for the capitalized costs of an amortizable Section 197 intangible and prohibits any other depreciation or amortization with respect to that property. Paragraphs (b), (c), and (e) of this section provide rules and definitions for determining whether property is a Section 197 intangible, and paragraphs (d) and (e) of this section provide rules and definitions for determining whether a Section 197 intangible is an amortizable Section 197 intangible. The amortization deduction under Section 197 is determined by amortizing basis ratably over a 15-year period under the rules of paragraph (f) of this section. Section 197 also includes various special rules pertaining to the disposition of amortizable Section 197 intangibles, nonrecognition transactions, anti-churning rules, and anti-abuse rules. Rules relating to these provisions are contained in paragraphs (g), (h), and (j) of this section. Examples demonstrating the application of these provisions are contained in paragraph (k) of this section. The effective date of the rules in this section is contained in paragraph (1) of this section.”). I.R.C. § 197(a) (“A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.”). On I.R.C. § 197 generally, see Barksdale Hortenstein, “Final Section 197 Regulations: Application to Partnership Transactions,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006; Mark J. Silverman, “Section 197 and Partnership Transactions,” in Practicing Law Institute, TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCs, JOINT VENTURES, & OTHER STRATEGIC ALLIANCES 2006.}
provides merely the briefest introduction. Planning for Section 197 intangibles can be a major part of planning for the organization of a partnership.

Congress has outdone itself in drafting a complicated Code provision in dealing with amortization of intangible property. Treasury and the IRS have drafted correspondingly complicated Treasury Regulations. The level of complexity of these Treasury Regulations rivals the complexity of the most complex Treasury Regulations. Only the IRS and Treasury believe Treasury Regulations are in plain English. As an example of the clarity of the Treasury Regulations, Treasury Regulations provide:

This paragraph (g)(2) provides rules relating to the treatment of section 197 intangibles acquired in certain transactions. If these rules apply to a section 197(f)(9) intangible (within the meaning of paragraph (h)(1)(i) of this section), the intangible is, notwithstanding its treatment under this paragraph (g)(2), treated as an amortizable section 197 intangible only to the extent permitted under paragraph (h) of this section.\textsuperscript{1139}

The task of deciphering portions of the Section 197 Treasury Regulations is absolutely staggering. A discussion of the details and subtleties of these rules is outside of the scope of this Article. This section provides merely a partial overview of the provisions affecting partnerships.

The basis of the intangible property is amortized over a fifteen-year period. These rules apply to “amortizable Section 197 intangibles” acquired after August 10, 1993, and held in connection with the conduct of a trade or business or an activity engaged in for the production of income. The rules under Section 197 are expressly limited to Section 197 intangibles. The Section 197 intangible rules under Section 197 are considerably more complicated than this discussion. This discussion will provide an introduction. The rules concerning “amortizable Section 197 intangibles” should be considered in the case of any transfer of intangibles to a partnership. Consider the effects of the Section 197 intangibles rules in structuring a contribution transaction to the partnership.

The Code permits a taxpayer to an amortization deduction with respect to any “amortizable Section 197 intangible.”\textsuperscript{1140} This deduction amortizes the basis of the “amortizable Section 197 intangible” over a fifteen-period. The amortization period begins with the month in which “amortizable Section 197 intangible” was acquired.\textsuperscript{1141} The Code formally defines a “Section 197 intangible” to include goodwill, going concern value, certain intellectual property, and certain other in-

\begin{itemize}
\item \textsuperscript{1139} Treas. Reg. § 1.197-2(g)(2)(i).
\item \textsuperscript{1140} I.R.C. § 197(a).
\item \textsuperscript{1141} \textit{Id.}
\end{itemize}
tangible assets of a going concern. An “amortizable section 197 intangible” is defined in the Code to include section 197 intangibles acquires after August 10, 1993 [date of enactment], acquired in connection with a trade or business or investment activity, but exclusive of self-created intangibles. “Section 197 intangibles” do not include, among other assets:

- Any interest in a corporation, partnership, trust, or estate, or
- Any interest in land.\textsuperscript{1142}
- Any right to receive tangible property or services under a contract or granted by a governmental unit or agency or instrumentality thereof not acquired in a transaction (or series of related transactions) involving the acquisition of assets constituting a trade business or substantial portion thereof.\textsuperscript{1143}
- Any interest in a patent or copyright.
- Any interest under an existing lease of tangible property.\textsuperscript{1144}

\begin{footnotes}
\textsuperscript{1142} Treas. Reg. § 1.197-2(c)(3) ("Interests in land. Section 197 intangibles do not include any interest in land. For this purpose, an interest in land includes a fee interest, life estate, remainder, easement, mineral right, timber right, grazing right, riparian right, air right, zoning variance, and any other similar right, such as a farm allotment, quota for farm commodities, or crop acreage base. An interest in land does not include an airport landing or takeoff right, a regulated airline route, or a franchise to provide cable television service. The cost of acquiring a license, permit, or other land improvement right, such as a building construction or use permit, is taken into account in the same manner as the underlying improvement.").

\textsuperscript{1143} Treas. Reg. § 1.197-2(c)(6) ("Certain rights to receive tangible property or services. Section 197 intangibles do not include any right to receive tangible property or services under a contract or from a governmental unit if the right is not acquired as part of a purchase of a trade or business. Any right that is described in the preceding sentence is not treated as a section 197 intangible even though the right is also described in section 197(d)(1)(D) and paragraph (b)(8) of this section (relating to certain governmental licenses, permits, and other rights) and even though the right fails to meet one or more of the requirements of paragraph (c)(13) of this section (relating to certain rights of fixed duration or amount). (See section 1.167(a)-14(c)(1) and (3) for applicable rules."").

\textsuperscript{1144} Treas. Reg. § 1.197-2(c)(8) ("Interests under leases of tangible property (i) Interest as a lessor. Section 197 intangibles do not include any interest as a lessor under an existing lease or sublease of tangible real or personal property. In addition, the cost of acquiring an interest as a lessor in connection with the acquire

(footnote continued on the next page)
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Any right to service indebtedness that is secured by residential real property unless the right is acquired in a transaction (or series of related transactions) involving the acquisition of assets (other than rights described in this paragraph) constituting a trade or business or substantial portion thereof.¹¹⁴⁵

Amortizable Section 197 intangibles are limited to intangibles acquired after August 10, 1993 and held in connection with the conduct of a trade or business or an activity described in section 212. The rules of Section 197 do not apply to intangibles acquired before that date. The amortizability of these assets is determined outside of Section 197.

Treasury Regulations permit the partnership to allocate amortization using any permitted method under the rules governing contributed property with a “book”-tax disparity (Section 704(c)) after a partner contributes an “amortizable Section 197 intangible” to a partnership.

The partnership is not permitted to amortize the contributed intangible when a partner contributes an intangible that was not an “amortizable Section 197 intangible” in the hands of the contributing partner. The partnership, however, is permitted to make remedial, but not curative, allocations of amortization deductions.

Taxpayers are entitled to their allocable shares of amortization deductions for Section 197 intangibles held through a partnership.

The taxpayer will step into the shoes of the transferor for purposes of Section 197 amortization to the extent that the taxpayer’s basis for the intangible does

¹¹⁴⁵ I.R.C. § 197(e).
not exceed its basis in the hands of the transferor if the taxpayer acquires an interest in a partnership that holds Section 197 intangibles.

Section 197 provides step-in-the-shoes rules that generally apply on the transfer of a Section 197 intangible to a partnership in a nonrecognition transaction—for example, a Section 721 contribution. The transfer to the partnership is generally disregarded in determining whether (to the extent of carryover basis) the intangible is treated as an “amortizable Section 197 intangible” and the amount of the Section 197 deduction with respect to the “amortizable Section 197 intangible”.

Goodwill and many other intangibles will be zero-tax-basis intangibles when contributed to the partnership. These intangibles must be depreciated for “book” purposes and may produce tax amortization deductions if the partnership uses the curative or remedial methods under the rules governing contributed property with a “book”-tax disparity (Section 704(c)). Treasury Regulations do not provide clear guidance concerning what this means. Treasury Regulations permit a partnership to use remedial or curative allocations to noncontributing partners of an asset that was amortizable in the hands of a contributing partner (or a zero-basis intangible that otherwise would have been amortizable in the hands of the contributor). Nonamortizable Section 197(f)(9) intangibles in the hands of the contributor are amortizable by the partnership through remedial allocations. (Naturally, no tax amortization is possible on account of the “ceiling rule” in the case of a contributed zero basis intangible when the partnership agreement applies the traditional method under the rules governing contributed property with a “book”-tax disparity (Section 704(c))). This results from the treatment of the property in effect as if it was purchased by the partnership. Curative allocations, however, are not permitted with respect to contributed nonamortizable Section 197(f)(9) intangibles.

The partnership generally steps into the shoes of the transferring partner when a partner contributes Section 197 intangibles to a partnership in a transaction in which gain or loss is not recognized in whole or in part:

- The Section 197 intangible may be amortizable in the hands of the contributing partner. Then,

---

1146 On the general subject of amortization of contributed intangibles, see K. Burke, *Partnership Inside Basis Adjustments and Remedial Allocations*, 2001 TNT 53-97 (March 9, 2001). This article also considers the interaction between remedial allocations and amortization of I.R.C. § 734 basis adjustments.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- It continues to be amortizable in the hands of the partnership (which continues to amortize the basis in the intangible using the transferor’s amortization period).

- The basis of the transferred Section 197 intangible may not be amortizable in the hands of the transferring partner (for example, the transferring partner was prevented from amortizing basis of a Section 197(f)(9) intangible under anti-churning rules). Then,
  - The carryover basis of the intangible continues to be non-amortizable in the hands of the transferor partnership. The partnership may still make remedial allocations with respect to the intangible.

- A Section 197 intangible may transferred to a partnership in a Section 721 contribution transaction or distributed by a partnership to a partner in a Section 731 transaction. Then,
  - The transfer is disregarded in determining whether (with respect to so much of the intangible's basis in the hands of the transferee as does not exceed its basis in the hands of the transferor) the intangible is an “amortizable Section 197 intangible” and the amount of the deduction under Section 197 with respect to this basis.

The transferee partnership will continue to amortize adjusted tax basis of a contributed Section 197 intangible, to the extent that the partnership’s adjusted tax basis does not exceed the transferor’s adjusted tax basis, ratably over the remainder of the transferor’s 15-year amortization period if an intangible contributed to a partnership in a Section 721 transaction was an “amortizable Section 197 intangible” in the hands of the transferor partner.

The transferee partnership’s adjusted tax basis (to the extent it does not exceed the transferor’s adjusted tax basis) cannot be amortized under Section 197 if the contributed intangible was not an “amortizable Section 197 intangible” in the hands of the transferor partner.

The intangible in either event is treated (with respect to so much of its adjusted tax basis in the hands of the transferee partnership as exceeds its adjusted tax basis in the hands of the transferor partner) in the same manner for purposes of Section 197 as an intangible acquired from the transferor in a transaction that is not subject to this rule.

A transaction in which a taxpayer acquires an interest in an intangible held through a partnership is treated as an acquisition to which Section 197 applies on-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

ly if, and to the extent that, the acquiring taxpayer obtains as a result of the transaction an increased basis for the intangible.\textsuperscript{1147} The increased basis in a nonrecognition transaction is treated as subject to a new amortization period. The carryover basis is treated to the same conventions as in the hands of the transferring partner. This rule applies to increased basis resulting from the contribution transaction or basis adjustments under Section 743 or 732 or 734. The portion of the intangible with the increased basis is treated as having a holding period beginning at the time of the basis increase.

Anti-churning rules of Section 197(f)(9) are important in applying the Section 197 intangibles rules to transfers to partnerships. These complex rules may prevent the amortization of a Section 197 intangible. Anti-churning rules under Section 197 are uncommonly complicated. The anti-churning rules are designed to prevent the conversion of assets held by the taxpayer during the period beginning on July 25, 1991, and ending on August 10, 1993, to “amortizable Section 197 intangibles.” Anti-churning rules apply to goodwill and going concern value held or used at any time during the transition period that was not amortizable or depreciable under the law prior to the effective date of Section 197 (July 25, 1991).

\section*{147. Section 1.752-7 Liabilities.}

Consider the effects of the transfer of contingent liabilities to a partnership in drafting your partnership agreement and understanding partnership economics. This has been an area of recent ferment in the tax laws. The Community Renewal Tax Relief Act of 2000\textsuperscript{1148} addressed certain situations in which property is transferred to a corporation in exchange for both stock and the corporation’s assumption of certain obligations of the transferor. Transferors took the position that certain obligations were not liabilities within the meaning of Section 357(c) or that they were described in Section 357(c)(3), and did not reduce the basis of the transferor’s stock. These assumed obligations, however, did reduce the value of the stock. The transferors then sold the stock and claimed a loss. Taxpayers attempted to duplicate a loss in corporate stock and to accelerate deductions that

\begin{itemize}
\item \textsuperscript{1147} H.R. Rep. No. 103-111, 103d Cong., 1\textsuperscript{st} Sess., at 774 (May 25, 1993).
\end{itemize}
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

often are allowed only on the economic performance of these types of obligations. This technique became the basis of several prominent marketed tax shelters. The Proposed Treasury Regulations that have resulted is not a model of user-friendliness.

Congress enacted Section 358(h) to cover transfers to corporations and provided for its extension to partnerships. This provision requires that, after the application of Section 358(d), the basis in stock received in an exchange to which Section 351, 354, 355, 356, or 361 applies be reduced (but not below the fair market value of the stock) by the amount of any liability assumed in the exchange. Section 358(h) creates exceptions when:

- The trade or business with which the liability is associated is transferred to the person assuming the liability as part of the exchange; or
- Substantially all of the assets with which the liability is associated are transferred to the person assuming the liability as part of the exchange.

“Liability” under Section 358(h) includes any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Code. Contingent obligations generally reduce tax basis in a Section 351 contribution transaction.

Section 358(h) addresses circumstances of Section 351 and similar transactions when taxpayers transfer property to corporations for stock and assumption of contingent obligations when taxpayers took the position that the obligations were not liabilities for tax purposes. Taxpayers would take the position that these obligations did not reduce stock basis, even though they reduced the value of the corporation. Section 358(h) generally provides that, if the basis of the stock that the transferring taxpayer receives exceeds its fair market value, the basis of the stock is reduced by the amount of any liability that is assumed in the exchange for the stock and that did not otherwise reduce the taxpayer’s basis in the stock by reason of the assumption. Section 358(h) does not reduce the transferring shareholder’s tax basis in the stock below the fair market value of the stock.

The transferring shareholder’s tax basis in his shares is not reduced if the trade or business with which the liability is associated is transferred to the corporation assuming the liability in the exchange.

Congress identified that taxpayers used partnerships for transactions incorporating the abuses at which Section 385(h) was directed. Congress instructed

---

1149 I.R.C. § 358(h)(3).
Treasury to prescribe rules to provide “appropriate adjustments under subchapter K of chapter 1 of the Code to prevent the acceleration or duplication of losses through the assumption of (or transfer of assets subject to) liabilities described in Section 358(h)(3) . . . in transactions involving partnerships.” These rules are to “apply to assumptions of liability after October 18, 1999, or such later date as may be prescribed in such rules.”

Complicated rules are provided for contingent liabilities transferred to partnerships. This as an abbreviated introduction to those rules. Treasury Regulations do not reduce the partner’s basis in the partnership at the time of the partnerships’ assumption of a Section 1.752-7 liability (a liability that would be a Section 358(h)(3) liability) of the partner by the partnership. The basis reduction is delayed until an event occurs that separates the partner from the liability (triggering event). Treasury Regulations describe these triggering events:

- A disposition (or partial disposition) of the partnership interest by the partner;
- A liquidation of the partner’s interest in the partnership; and
- The assumption of the liability by another partner.

When a triggering event occurs and the basis reduction is made, the partnership’s (or the assuming partner’s) deduction on the economic performance of the Section 1.752-7 liability is limited. The partner may take a loss or deduction in the amount of the prior basis reduction if the partnership (or the assuming partner) notifies the partner of the economic performance of the Section 1.752-7 liability.

Treasury Regulations include an exception for transactions in which the partner contributes to the partnership the trade or business with which the liability is associated as part of the exchange (the trade or business exception). Treasury Regulations do not include an exception for transactions in which the partner contributes to the partnership substantially all of the assets associated with the liability as part of the exchange. Treasury Regulations include an additional exception for situations in which, immediately before the triggering event, the amount of the remaining built-in loss with respect to all Section 1.752-7 liabilities assumed by the partnership (other than Section 1.752-7 liabilities assumed by the partnership with an associated trade or business) in one or more Section 1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or $1,000,000 (the de minimis exception).

Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

The loss limiting rules of the Section 1.752-7 Treasury Regulations (specifically addressing transfer of Section 1.752-7 liability partner’s partnership interest, distribution in liquidation of Section 1.752-7 liability partner’s partnership interest, and assumption of Section 1.752-7 liability by a partner other than Section 1.752-7 liability partner) do not apply if the partnership assumes the Section 1.752-7 liability as part of a contribution to the partnership of the trade or business with which the liability is associated, and the partnership continues to carry on that trade or business after the contribution.

The loss limiting rules of the Section 1.752-7 Treasury Regulations (specifically addressing transfer of Section 1.752-7 liability partner’s partnership interest, distribution in liquidation of Section 1.752-7 liability partner’s partnership interest, and assumption of Section 1.752-7 liability by a partner other than Section 1.752-7 liability partner) do not apply if, immediately before the testing date, the amount of the remaining built-in loss with respect to all Section 1.752-7 liabilities assumed by the partnership (other than Section 1.752-7 liabilities assumed by the partnership with an associated trade or business) in one or more Section 1.752-7 liability transfers is less than the lesser of 10% of the gross value of partnership assets or $1,000,000.

A trade or business is a specific group of activities carried on by a person for the purpose of earning income or profit, other than a group of activities consisting of acquiring, holding, dealing in, or disposing of financial instruments, if the activities included in that group include every operation that forms a part of, or a step in the process of earning income or profit. The group of activities ordinarily includes the collection of income and the payment of expenses. The group of activities must constitute the carrying on of a trade or business under section 162(a) (determined as though the activities were conducted by an individual).

The testing date is –

- For purposes of the rules concerning transfer of Section 1.752-7 liability partner’s partnership interest,\textsuperscript{1151} the date of the sale, exchange, or other disposition of part or all of the Section 1.752-7 liability partner’s partnership interest;

- For purposes of rules concerning distribution in liquidation of Section 1.752-7 liability partner’s partnership interest (Treasury Regulations Section 1.752-7(f)), the date of the partnership’s distribution in liquidation of the Section 1.752-7 liability partner’s partnership interest; and

\textsuperscript{1151} Treas. Reg. § 1.752-7(e).
For purposes of rules concerning assumption of Section 1.752-7 liability by a partner other than Section 1.752-7 liability partner (Treasury Regulations Section 1.752-7(g)), the date of the assumption (or partial assumption) of the Section 1.752-7 liability by a partner other than the Section 1.752-7 liability partner.

The Section 1.752-7 Treasury Regulations provide detailed rules to address the treatment of the liability between the date of the assumption of that liability by the partnership and the date of a triggering event and to address tiered entity situations.

Treasury Regulations distinguish between a Section 1.752-1 liability (for which a basis reduction is required when the liability is assumed by the partnership from a partner) and a Section 1.752-7 liability (for which a basis reduction is not required until the occurrence of a triggering event). An obligation is a Section 1.752-1 liability to the extent that the obligation creates or increases the basis of any of the obligor’s assets (including cash), gives rise to an immediate deduction to the obligor, or gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital. All remaining obligations are Section 1.752-7 liabilities. Section 1.752-7 liabilities are subject to the rules for allocating losses associate with a “book”-tax disparity (Section 704(c)).

The partnership rules are intended to prevent the acceleration or duplication of loss through the assumption of obligations not described in Treasury Regulations Section 1.752-1(a)(4)(i) in transactions involving partnerships. Any Section 1.752-7 liability that is assumed by a partnership from a partner in a transaction governed by Section 721(a) is treated as contributed property with a “book”-tax disparity (Section 704(c) property). Rules in Treasury Regulations prevent the duplication of loss by prohibiting the partnership and any person other than the partner from whom the obligation was assumed from claiming a deduction, loss, or capital expense to the extent of the built-in loss associated with the Section 1.752-7 obligation. These rules prevent the acceleration of loss by deferring the partner’s deduction or loss attributable to the obligation (if any) until the satisfaction of the Section 1.752-7 liability.

A Section 1.752-7 liability is an obligation described in Treasury Regulations Section 1.752-1(a)(4)(ii) to the extent that either –

- The obligation is not described in Treasury Regulations Section 1.752-1(a)(4)(i); or
- The amount of the obligation exceeds the amount taken into account under Treasury Regulations Section 1.752-1(a)(4)(i).

Treasury Regulations formally define “liability”: 
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

(4) Liability defined

(i) In general. An obligation is a liability for purposes of section 752 and the regulations thereunder (§ 1.752-1 liability), only if, when, and to the extent that incurring the obligation –

(A) Creates or increases the basis of any of the obligor’s assets (including cash);

(B) Gives rise to an immediate deduction to the obligor; or

(C) Gives rise to an expense that is not deductible in computing the obligor’s taxable income and is not properly chargeable to capital.

(ii) Obligation. For purposes of this paragraph and § 1.752-7, an obligation is any fixed or contingent obligation to make payment without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.\footnote{1152}

Certain obligations that create liabilities under the normal liability rules\footnote{1153} may create Section 1.752-7 liabilities. A fixed obligation that gives rise to basis can have a component portion that changes in value between the time the obligation is first incurred by the partner and the time when the partnership assumes the obligation due to changes in interest rates, stock price, or other similar factors. The value of the obligation to the holder has increased in these and other cases, and, as a result, the cost to the obligor has increased by a like amount. An obligation can be treated in part as a Section 1.752-7 liability and in part as a Section 1.752-1 liability.

The amount of a Section 1.752-7 liability is the amount of cash that a willing assignor would pay to a willing assignee to assume the Section 1.752-7 liability in an arm’s-length transaction. The amount of the Section 1.752-7 liability is the amount of cash (if any) that a willing assignor would pay to a willing assignee to assume the entire contract if the obligation arose under a contract in exchange for rights granted to the obligor under that contract (and those contractual rights

\footnote{1152}{Treas. Reg. § 1.752-1(a)(4).}
\footnote{1153}{Treas. Reg. § 1.752-1.}
are contributed to the partnership in connection with the partnership’s assumption of the contractual obligation).

Each partner’s share of a partnership’s Section 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the Section 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than Section 1.752-7 liabilities), and paid an unrelated person to assume all of its Section 1.752-7 liabilities in a fully taxable arm’s-length transaction (assuming the payment would give rise to an immediate deduction to the partnership).

A Section 1.752-7 liability transfer in general is any assumption of a Section 1.752-7 liability by a partnership from a partner in a transaction governed by section 721(a).

A Section 1.752-7 liability partner is a partner from whom a partnership assumes a Section 1.752-7 liability as part of a Section 1.752-7 liability transfer or any person who acquires a partnership interest from the Section 1.752-7 liability partner in a transaction to which Treasury Regulations Section 1.752-7(e)(3) applies.

The remaining built-in loss associated with a Section 1.752-7 liability equals:

- The amount of the Section 1.752-7 liability as of the time of the assumption of the Section 1.752-7 liability by the partnership, reduced by

- The portion of the Section 1.752-7 liability previously taken into account by the Section 1.752-7 liability partner and adjusted for –
  - Any portion of that built-in loss associated with the Section 1.752-7 liability that is satisfied by the partnership on or prior to the testing date (whether capitalized or deducted); and
  - Any assumption of all or part of the Section 1.752-7 liability by the Section 1.752-7 liability partner (including any assumption that occurs on the testing date).

The remaining built-in loss associated with Section 1.752-7 liability is prorated based on the portion of the partnership interest sold or the portion of the Section 1.752-7 liability assumed in the case of a partial disposition of the Section 1.752-7 liability partner’s partnership interest or a partial assumption of the Section 1.752-7 liability by another partner.

The Section 1.752-7 liability partner is permitted to claim a loss or deduction upon “economic performance” of the Section 1.752-7 liability.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

Section 1.752-7 liabilities may be settled in cash or in kind, extinguished, satisfied or otherwise resolved under circumstances when there may not be an “economic performance” of the Section 1.752-7 liabilities. Economic performance applies to “liabilities” under Treasury Regulations Section 1.446-1(c)(1)(ii)(B). Some Section 1.752-7 liabilities may not come within the meaning of that term. The Section 1.752-7 liability partner to claim a loss or deduction under Section 1.752-7 upon the satisfaction of the Section 1.752-7 liability.

A Section 1.752-7 liability is treated as satisfied on the date upon which, but for Section 1.752-7, the partnership, or the assuming partner, would have been allowed to take the Section 1.752-7 liability into account for federal tax purposes. A Section 1.752-7 liability is treated as satisfied (in whole or in part) on the date when the partnership (or the assuming partner) would have been allowed to take the Section 1.752-7 liability into account for federal tax purposes but for this section. A Section 1.752-7 liability is treated as satisfied when, but for the special rules concerning contingent liabilities, the Section 1.752-7 liability would give rise to –

- An increase in the basis of the partnership’s or the assuming partner’s assets (including cash);
- An immediate deduction to the partnership or to the assuming partner;
- An expense that is not deductible in computing the partnership’s or the assuming partner’s taxable income and not properly chargeable to capital account; or
- An amount realized on the sale or other disposition of property subject to that liability if the property was disposed of by the partnership or the assuming partner at that time.

Any Section 1.752-7 liability assumed by a partnership in a Section 1.752-7 liability transfer is treated under principles for allocating loss on property with a “book”-tax disparity (Section 704(c) principles) as having a built-in loss equal to the amount of the Section 1.752-7 liability (as of the date of the partnership’s assumption of the Section 1.752-7 liability). Section 704(c)(1)(B) does not apply to the assumption and instead the rules of Section 1.752-7(g) apply if a Section 1.752-7 liability is assumed from the partnership by a partner other than the Section 1.752-7 liability partner, and the trade or business or de minimis exceptions does not apply.

Built-in gain or loss must be allocated to the transferee partner as it would have been allocated to the transferor partner if a contributing partner transfers a partnership interest.
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

All of the rules of Section 704(c), Treasury Regulations Section 1.704-3, and Treasury Regulations Section 1.704-4 (including Section 704(c)(1)(B)), apply to Section 1.752-7 liabilities unless otherwise specifically stated. Section 1.752-7 liabilities are section 704(c) property. The successor partner rule in general does not apply to Section 1.752-7 liabilities.

On a post-assumption change in the value of the Section 1.752-7 liability, resulting in an obligation amount that is either greater or less than the initial amount of the obligation, the change in the amount will be treated as a Section 704(b) item and not an item associated with property contributed with a “book”-tax disparity (a Section 704(c) item). The post-assumption change in value will create “book” income or loss to be allocated to the partners.

The “ceiling rule” applies if the value of the Section 1.752-7 liability decreases after the assumption of the obligation by the partnership, and the partnership and the partners are entitled to adopt one of the reasonable methods specified in the rules concerning allocations with respect to contributed property in order to correct any ceiling rule disparities.

To the extent a partnership properly capitalizes all or a portion of an item as described in Treasury Regulations Section 1.704-3(a)(12), then the item or items to which the cost is properly capitalized is treated as contributed property with a “book”-tax disparity (Section 704(c) property) with the same amount of built-in loss as corresponds to the amount capitalized.

No reduction in the partner’s basis in the partnership interest is required with respect to a capitalized amount as a result of a triggering event. After the triggering event, neither the partnership nor the remaining partners may use the capitalized basis.

Section 707(a)(2)(B) provides that when a partner makes a direct or indirect transfer of money or other property to a partnership and the partnership makes a related direct or indirect transfer of money or property to the partner and the transfers, when viewed together, are properly characterized as a sale or exchange, the reciprocal transfers are treated either as a transaction between the partnership and one who is not a partner, or as a transaction between two or more partners acting other than in their capacity as members of the partnership. Treasury Regulations consider all liabilities, regardless of whether those liabilities are taken into account under the partnership rules for allocating liabilities among partners (Section 752). The disguised sale rules under Section 707 may include Section 1.752-7 liabilities as consideration.

---

SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

Treasury Regulations Section 1.704-1(b)(2)(iv)(b) generally requires that a partner’s capital account be increased by the value of property contributed by
the partner to the partnership net of liabilities secured by the contributed property
that the partnership is considered to assume or take subject to under the partnership rules for allocating liabilities among partners (Section 752), and be decreased by
the value of property distributed by the partnership to the partner net of liabilities
secured by the distributed property that the partner is considered to assume or take subject to under the partnership rules for allocating liabilities among partners
(Section 752). Section 1.704-1(b)(2)(iv)(c) requires that a partner’s capital account be increased by liabilities of the partnership that are assumed by the partner
(other than liabilities described in Section 1.704-1(b)(2)(iv)(b)(5)), and be decreased by liabilities of the partner that are assumed by the partnership (other than
liabilities described in Treasury Regulations Section 1.704-1(b)(2)(iv)(b)(2)).
Treasury Regulations Section 1.704-1(b)(2)(iv)(b) takes into account all liabilities
to which the contributed or distributed property is subject, not just liabilities
described in the partnership rules for allocating liabilities among partners. Treasury Regulations Section 1.704-1(b)(2)(iv)(b) is no longer limited to liabilities
described in the partnership rules for allocating liabilities among partners.

Treasury Regulations do not include guidance on acceptable methods for
identifying and valuing Section 1.752-7 liabilities, or identifying the appropriate
discount rate for determining the liability’s present value. This is left to the nego-
tiation of the financial arrangement among the parties. The preamble to the Sec-
tion 1.752-7 Treasury Regulations observes that the parties will take the potential
occurrence of these obligations into account in arriving at the agreement among
the parties that will govern their affairs (including the appropriate valuation meth-
ology to apply to these obligations). However, if the obligation arose under a
contract in exchange for rights granted to the obligor under that contract, and
those contractual rights are contributed to the partnership in connection with the
partnership’s assumption of the contractual obligation, then the amount of the
Section 1.752-7 liability is the amount of cash (if any) that a willing assignor
would pay to a willing assignee to assume the entire contract.

A Section 1.752-7 liability might arise under a contract in exchange for
rights granted to the obligor under that contract, and those contractual rights
might be contributed to the partnership in connection with the partnership’s
assumption of the contractual obligation. The amount of the Section 1.752-7 liab-
ility then is the amount of cash (if any) that a willing assignor would pay to a will-
ing assignee to assume the entire contract. The amount of a Section 1.752-7 liab-
ility (or, the amount of an obligation) is the amount of cash that a willing assignor
would pay to a willing assignee to assume the Section 1.752-7 liability in an
arm’s-length transaction. The amount of the Section 1.752-7 liability or obligation
is the amount of cash (if any) that a willing assignor would pay to a willing as-
signee to assume the entire contract if the obligation arose under a contract in ex-
change for rights granted to the obligor under that contract, and those contractual rights are contributed to the partnership in connection with the partnership’s assumption of the contractual obligation. A partner’s share of a partnership’s Section 1.752-7 liability is the amount of deduction that would be allocated to the partner with respect to the Section 1.752-7 liability if the partnership disposed of all of its assets, satisfied all of its liabilities (other than Section 1.752-7 liabilities), and paid an unrelated person to assume all of its Section 1.752-7 liabilities in a fully taxable arm’s-length transaction (assuming the payment would give rise to an immediate deduction to the partnership).

148. Investment Partnerships.

Be vigilant if you are drafting a partnership agreement for a partnership that is principally capitalized with stocks and securities. A transfer of property (including a transfer of real property) to a partnership that would be treated as an investment company if it were a corporation, is usually a fully taxable transaction. This is frequently a problem with transfers to family partnerships that are principally capitalized with stocks and securities. Many advisors are surprised that these transfers may be fully taxable. The rules regarding in-kind capital contributions, as well as their application, are complicated. These rules should be applied by a competent tax professional.\footnote{I.R.C. §§ 351(e), 721(b); Treas. Reg. § 1.351-1(c).} The investment company rules can be particularly a problem when you are organizing a family limited partnership and the principal asset is a concentrated position in stock or securities.

A transfer of property to a partnership that would be treated as an investment company, if formed as corporation, is generally fully taxable.\footnote{I.R.C. §§ 351(e).} This applies to all transfers of property to that investment company – not just transfers of stock and securities. At least, the transfer is taxable if the transfer results, directly or indirectly, in diversification of the transferors’ interests.

Whether a partnership should be treated as an investment company is ordinarily determined by reference to the circumstances in existence immediately after the transfer. The determination considers the changed circumstances where circumstances change thereafter under a plan in existence at the time of the transfer.\footnote{Treas. Reg. § 1.351-1(c)(2).}

A partnership generally will be treated as an investment company if more than 80 percent of the value of the partnership’s assets (excluding cash and non-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Convertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts.\(^\text{1159}\) This requirement can be avoided by ensuring that 80 percent or less of the value of the partnership’s assets (excluding cash and nonconvertible debt obligations from consideration) are held for investment and are readily marketable stocks or securities, or interests in regulated investment companies or real estate investment trusts. Partnerships often will acquire interests in real property or in partnerships owning real property in order to avoid classification as investment companies.

Stocks and securities are considered readily marketable if (and only if) they are part of a class of stock or securities that is traded on a securities exchange or traded or quoted regularly in the over-the-counter market.\(^\text{1160}\)

“Readily marketable stocks or securities” includes –

- Convertible debentures.
- Convertible preferred stock.
- Warrants.
- Other stock rights if the stock for which they may be converted or exchanged is readily marketable.\(^\text{1161}\)

Stocks and securities are considered to be held for investment unless they are –

- Held primarily for sale to customers in the ordinary course of business; or
- Used in the trade or business of banking, insurance, brokerage, or a similar trade or business.

A “dealer” or brokerage partnership holds stocks and securities for sale to customers in the ordinary course of business. This partnership should not normal-

---

\(^\text{1159}\) Treas. Reg. § 1.351-1(c)(1)(ii)(c).

\(^\text{1160}\) Treas. Reg. § 1.351-1(c); cf. Treas. Reg. § 1.367(a)-1T(c)(3)(ii)(d)(iii) (“An over-the-counter market. An over-the-counter market is any market reflected by the existence of an inter-dealer quotation system. An inter-dealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stock and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.”); Treas. Reg. § 1.883-2(b)(4).

\(^\text{1161}\) Treas. Reg. § 1.351-1(c)(3).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

... constitute an investment company. The investment company rules can be avoided by ensuring that the partnership is treated as holding its stock and securities assets as “inventory” – that is “for sale to customers in the ordinary course of business” or that is used in a brokerage business. The investment company rules can be avoided if the partnership is undertaking the trade or business of banking, insurance, or a similar trade or business. 1162

Stock and securities in subsidiary corporations is disregarded. The parent corporation is treated as owning its ratable share of its subsidiaries’ assets. A corporation is considered a subsidiary if the parent owns 50 percent or more of –

- The combined voting power of all classes of stock entitled to vote; or
- The total value of shares of all classes of stock outstanding. 1163

The determination of whether a partnership is an investment company is made by taking into account all stock and securities held by the partnership. 1164 These assets are treated as stock and securities for purposes of determining whether a partnership is an investment company –

- (i) money;
- (ii) stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts and derivatives;
- (iii) any foreign currency;
- (iv) any interest in a real estate investment trust, a common trust fund, a regulated investment company, a publicly-traded partnership (as defined in Section 7704(b) or any other equity interest (other than in a corporation) which pursuant to its terms or any other arrangement is readily convertible into, or exchangeable for, any asset described in any preceding clause, this clause or clause (v) or (viii);
- (v) except to the extent required in Treasury Regulations prescribed by the Secretary of the Treasury, any interest in a precious metal, unless such metal is used or held in the active conduct of a trade or business after the contribution;

1162 Id.
1163 Treas. Reg. § 1.351-1(c).
1164 I.R.C. § 351(e)(1).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING Partnership and LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

• (vi) except as otherwise required in Treasury Regulations prescribed by the Secretary of the Treasury, interests in any entity if substantially all of the assets of such entity consist (directly or indirectly) of any assets described in any preceding clause or clause (viii);

• (vii) to the extent required in Treasury Regulations prescribed by the Secretary of the Treasury, any interest in any entity not described in clause (vi), but only to the extent of the value of such interest that is attributable to assets listed in clauses (i) through (v) or clause (viii); or

• (viii) any other asset specified in Treasury Regulations prescribed by the Secretary of the Treasury.\textsuperscript{1165}

Any contribution transaction that involves one or more transfers of non-identical assets which, taken in the aggregate, constitute an insignificant portion of the total value of assets transferred, will have these transfers disregarded in determining whether the transfers result in diversification.\textsuperscript{1166}

The transfer to a newly organized partnership will generally be treated as not resulting in diversification if the transfer to the partnership involves only one transferor (or two or more transferors of identical assets). The same rule applies if two or more transferors transfer identical assets to a newly organized partnership. A transfer might be part of a plan to achieve diversification without recognition of gain. The original transfer will be treated as resulting in diversification. An example of such a transfer is a transfer under a plan which contemplates a subsequent transfer, however delayed, of the partnership assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment.\textsuperscript{1167}

A transfer of stocks and securities to a partnership will not be treated as resulting in a diversification of the transferors’ interests if each transferor transfers a diversified portfolio of stocks and securities. A portfolio of stocks and securities is diversified if it satisfies the 25 and 50-percent tests of the reorganization rules of Section 368(a)(2)(F)(ii), applying the relevant provisions of Section 368(a)(2)(F).\textsuperscript{1168}

A particular transferor likely will not recognize gain or loss if the particular transferor transfers a diversified portfolio of stocks and securities.

\textsuperscript{1165} I.R.C. § 351(e)(1)(B).
\textsuperscript{1166} Treas. Reg. § 1.351-1(c)(5).
\textsuperscript{1167} Id.
\textsuperscript{1168} Treas. Reg. § 1.351-1(c)(6)(i).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

A portfolio of stocks will satisfy the diversification tests of Section 368(a)(2)(F)(ii) if –

- Not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer; and
- Not more than 50 percent of the value of its total assets is invested in the stock and securities of 5 or fewer issuers. All members of a controlled group of corporations (within the meaning of Section 1563(a)) are treated as one issuer.\textsuperscript{1169}

“Securities” for purposes of the diversification tests includes obligations of State and local governments, commodity futures contracts, shares of regulated investment companies and real estate investment trusts, and other investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36) [80a-2(a)(36)]).\textsuperscript{1170}

Government securities are included in total assets for purposes of the denominator of the 25 and 50-percent tests (unless the Government securities are acquired to meet the 25 and 50-percent tests), but are not treated as securities of an issuer for purposes of the numerator of the 25 and 50-percent tests.\textsuperscript{1171} This special rule is applied for determining an “investment company” for purposes of the partnership rules and for purposes of determining a corporation that is an “investment company” for purposes of Section 351. In measuring diversified portfolio, in determining total assets, cash and cash items (including receivables), Government securities, and, under Treasury Regulations prescribed by the Secretary, assets acquired (through incurring indebtedness or otherwise) for purposes of meeting the requirements of clause (ii) in the regulations or ceasing to be an investment company, are excluded.

Individuals A, B, and C organize a partnership with 101 shares of common stock. A and B each transfers to it $10,000 worth of the only class of stock of corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. C transfers $200 worth of readily marketable securities in corporation Y for one share of stock. In determining whether or not diversification has occurred, C’s participation in the transaction will be disregarded. There is no diversification. Gain or loss will not be recognized.

A, together with 50 other transferors, organizes a partnership with 100 shares of stock. A transfers $10,000 worth of stock in corporation X, listed on the New York Stock Exchange, in exchange for 50 shares of stock. Each of the other

\textsuperscript{1169} I.R.C. § 368(a)(2)(F)(ii).
\textsuperscript{1170} I.R.C. §§ 368(a)(2)(F)(vii).
\textsuperscript{1171} Id.
50 transferors transfers $200 worth of readily marketable securities in corporations other than X in exchange for one share of stock. All transfers will be taken into account in determining whether or not diversification has occurred. Diversification is present, and gain or loss will be recognized.

149. Qualified Organizations and the Fractions Rule.

Special rules apply to allocations in partnership agreements in situations in which certain qualified organizations are direct or indirect partners. Common qualified organizations are tax-exempt universities, colleges and private schools and tax-qualified pension plan trusts. Allocations for these partnership agreements are subject to the complex "fractions rule" that must be satisfied in order for the otherwise tax-exempt entity to avoid taxable income on account of partnership liabilities. Drafting partnership allocations for these partnerships is a complex task. Leave this task to specialists. The details of these rules are outside of the scope of this Article. This Article discusses the "fractions rule" only generally. If you are drafting a partnership agreement for a partnership that includes qualified organizations, you must fully engage the fractions rule. The fractions rule is made to be applied by specialists. The fractions rule is relevant not only in determining debt financed income, but similar rules concerning “qualified allocations” apply under the depreciation rules of Section 168 and the loss limitation rules of Section 470. The Section 514(c)(9)(E) exception applies to qualified organizations only if either:

- All of the partners in the partnership are qualified organizations, or
- Each of the allocations in the partnership agreement made to a partner that is a qualified organization is a qualified allocation (that is, satisfies the "fractions rule).

The general principle of the fractions rule is that, to satisfy the fractions rule and to avoid debt-financed income, a tax-exempt pension plan or educational organization cannot receive allocations of income greater than its smallest allocation of partnership loss. The concern is that the partnership is disproportionately allocating taxable income to nontaxable partners. The fractions rule greatly restricts allocations in the partnership agreement. A typical allocation to a promoter

---

1172 Such as tax qualified pension plans, educational organizations or other organizations defined in I.R.C. § 514(c)(9)(C).
1173 I.R.C. § 514(c)(9)(E).
1174 See discussion in text accompanying note 1247.
1175 See discussion in text accompanying note 1248.
that results in an increase in the profits allocated to the promoter after the investors have received a benchmark amount does not satisfy the fractions rule and results in the partnership failing Section 514(c)(9)(E). The fractions rule additionally contains limitations on guaranteed payments to the promoter.

a. Unrelated Business Taxable Income.

Tax-exempt organizations often are taxable on certain forms of income. Unrelated business taxable income is taxed to most tax-exempt organizations. Income from income-producing property that is acquired with “acquisition indebtedness” is generally taxable, even to most tax-exempt organizations.\footnote{I.R.C. § 514.} As a general matter, “‘debt-financed property’ means any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in subsection (c)) at any time during the taxable year (or, if the property was disposed of during the taxable year, with respect to which there was an acquisition indebtedness at any time during the 12-month period ending with the date of such disposition).”\footnote{I.R.C. § 514(b)(1).}

b. Acquisition Indebtedness.

“Acquisition indebtedness” is the unpaid amount of:

- The indebtedness incurred by the organization in acquiring or improving the property;
- The indebtedness incurred before the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement; and
- The indebtedness incurred after the acquisition or improvement of the property if the indebtedness would not have been incurred but for the acquisition or improvement and the incurrence of the indebtedness was reasonably foreseeable at the time of the acquisition or improvement.\footnote{I.R.C. § 514(c).}

The amount of the indebtedness secured by the mortgage or lien, when property is acquired subject to a mortgage or other similar lien, is considered as an indebtedness of the organization incurred in acquiring the property even though the organization did not assume or agree to pay the indebtedness.\footnote{I.R.C. § 514(c)(2)(A).}
Special rules apply when certain tax exempt organizations invest in debt-financed property. Real property subject to acquisition indebtedness generally will constitute debt-financed property subject to the unrelated business income rules. “Acquisition indebtedness” generally does not include indebtedness incurred by a qualified organization in acquiring or improving any real property. As a consequence, when this rule applies, the property does not generate debt-financed income. An interest in a mortgage shall in no event be treated as real property.

The rule that “acquisition indebtedness” does not include indebtedness incurred by a qualified organization (an educational organization described in Section 170(b)(1)(A)(ii), its affiliated support organizations, a qualified pension trust, or a real estate holding company described in Section 501(c)(25)) in acquiring or improving any real property does not apply to any case (and therefore the property will produce unrelated business income) in which—

- (i) The price for the acquisition or improvement is not a fixed amount (for example, the property has a contingent price) determined as of the date of the acquisition or the completion of the improvement;

- (ii) The amount of any indebtedness or any other amount payable with respect to the indebtedness, or the time for making any payment of any such amount, is dependent (in whole or in part) upon any revenue, income, or profits derived from the real property (that is, the debt is participating debt with participating interest);

- (iii) The real property is at any time after the acquisition leased by the qualified organization to the person selling the property to the organization or to any person who bears a relationship described in Section 267(b) or 707(b) to this person (real property leased to a related person);

- (iv) The real property is acquired by a qualified trust (pension trust) from, or is at any time after the acquisition leased by the trust to, any person who—

---

1180 I.R.C. § 514(c)(9)(A).
1181 I.R.C. § 514(c)(9)(A).
1182 I.R.C. § 514(c)(9)(B)(i). Query: what is the effect of a renegotiated purchase price?
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Bears a relationship that is described in subparagraph (C), (E), or (G) of Section 4975(e)(2) to any plan with respect to which the trust was formed, or
- Bears a relationship that is described in subparagraph (F) or (H) of Section 4975(e)(2) to any person described in subclause (I);[^1185]

(v) Any person described in clause (iii) or (iv) provides the qualified organization with financing in connection with the acquisition or improvement (that is, related party financing);[^1186] or

(vi) The real property is *held by a partnership* unless the partnership meets the requirements of clauses (i) through (v) and unless–

- All of the partners of the partnership are qualified organizations [for this purpose, an organization is not be treated as a qualified organization if any income of the organization is unrelated business taxable income],
- Each allocation to a partner of the partnership that is a qualified organization is a qualified allocation,[^1187] or
- The partnership meets the requirements of the fractions rule.^[1188]

c. Qualified Organizations.

The scope of “qualified organization” is considerably narrower than tax-exempt organizations and even narrower than Section 501(c)(3) organizations. A “qualified organization” is –

- An organization described in Section 170(b)(1)(A)(ii) [“an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on”] and its affiliated support organizations described in section 509(a)(3) [“an organization which—(A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2), (B) is operated, supervised, or controlled by or in connec-

[^1187]: Within the meaning of I.R.C. § 168(h)(6).
some comments on how to compromise drafting partnership and llc agreements and some basic issues in drafting real estate partnership and llc agreements

tion with one or more organizations described in paragraph (1) or (2), and (C) is not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more organizations described in paragraph (1) or (2)”];

- Any trust that constitutes a qualified trust under Section 401 [“[a] trust created or organized in the United States and forming part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of his employees or their beneficiaries . . .”];

- An organization described in Section 501(c)(25) [“Any corporation or trust which–(i) has no more than 35 shareholders or beneficiaries, (ii) has only 1 class of stock or beneficial interest, and (iii) is organized for the exclusive purposes of–(I) acquiring real property and holding title to, and collecting income from, such property, and (II) remitting the entire amount of income from such property (less expenses) to 1 or more organizations described in subparagraph (C) which are shareholders of such corporation or beneficiaries of such trust.”].

d. Fractions Rule.

Allocations in the partnership agreement are “qualified allocations” only if the allocations satisfy the “fractions rule.”

The general principle of the fractions rule is that, to satisfy the fractions rule and to avoid debt-financed income, a tax-exempt pension plan or educational organization cannot receive allocations of income greater than its smallest allocation of partnership loss. The concern is that the partnership is disproportionately allocating taxable income to nontaxable partners. The fractions rule is a rule of considerable sophistication and complexity that should be applied with the greatest care. The fractions rule often is the province of highly trained tax professionals. The material in this Article provides only a general introduction to the fractions rule.

The fractions rule requires that –

- The allocation of items (“book” items) to any partner that is a qualified organization cannot result in the partner having a share of the

---

1189 I.R.C. § 514(c)(9)(C)(i).
1192 Consider the application of I.R.C. § 168(h)(6) and I.R.C. § 470. I.R.C. § 470 is discussed in note 1248.
overall partnership income ("book" income) for any taxable year greater than the partner’s share of the overall partnership loss ("book" loss) for the taxable year for which the partner’s loss share will be the smallest,\footnote{1193} and

- Each allocation with respect to the partnership has substantial economic effect.\footnote{1194}

The fractions rule generally provides that the partnership cannot disproportionately allocate income to a qualified organization. The fractions rule is easily violated – including violation through inadvertence.

The fractions rule requires that allocations satisfy the rules of substantial economic effect and the nonrecourse deduction safe harbor if a qualified organization is a partner. All of the allocations in a partnership agreement must be qualified allocations in order for a qualified organization to avoid the debt-financed income rules. As a practical matter, a qualified organization usually will invest in a real estate investment partnership only if all allocations are qualified allocations.

\section*{i) Section 704(c) Items Are Excluded.}

Items allocated under the partnership tax rules concerning contributed property with differences between fair market value and adjusted tax basis (Section 704(c)(1)(A)) are not taken into account in applying the fractions rule.\footnote{1195} The fractions rule operates on partnership “book” items only.

\section*{ii) Prospective Satisfaction of Fractions Rule.}

The partnership must satisfy the fractions rule prospectively. The partnership must satisfy the fractions rule commencing with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a

\footnote{1193} I.R.C. § 514(c)(9)(E)(i)(I).
\footnote{1194} Within the meaning of I.R.C. § 704(b)(2). I.R.C. § 514(c)(9)(E)(i)(II); Treas. Reg. § 1.514(c)-2(b)(1)(ii) ("Each partnership allocation must have substantial economic effect. However, allocations that cannot have economic effect must be deemed to be in accordance with the partners’ interests in the partnership pursuant to section 1.704-1(b)(4), or (if section 1.704-1(b)(4) does not provide a method for deeming the allocations to be in accordance with the partners’ interests in the partnership) must otherwise comply with the requirements of section 1.704-1(b)(4). Allocations attributable to nonrecourse liabilities or partner nonrecourse debt must comply with the requirements of section 1.704-2(e) or section 1.704-2(i).")\footnote{1195} Treas. Reg. § 1.514(c)-2(b)(1).
qualified organization as a partner. The partnership must satisfy the fractions rule for each taxable year of the partnership, commencing with the first taxable year of the partnership in which the partnership holds debt-financed real property and has a qualified organization as a partner. A partnership generally does not qualify for the unrelated business income tax exception for any taxable year of its existence unless it satisfies the fractions rule for every year the fractions rule applies.

iii) Changes to Partnership Agreement.

A subsequent change to a partnership agreement that causes the partnership to violate the fractions rule ordinarily causes the partnership’s income to fail the fractions rule only for the taxable year of the change and subsequent taxable years. The subsequent change does not have a retroactive effect.

iv) Fractions Rule Percentage.

The fractions rule provides that the allocation of items to a partner that is a qualified organization cannot result in that partner having a percentage share of overall partnership income (“book” income) for any partnership taxable year greater than that partner’s fractions rule percentage.

A qualified organization’s fractions rule percentage is:

- The qualified organization’s percentage share of
- Overall partnership loss (“book” loss)

---

1196 Treas. Reg. § 1.514(c)-2(b)(2).
1197 Treas. Reg. § 1.514(c)-2(b)(2)(1) (“However, if an actual allocation described in paragraph (e)(4), (h), (j)(2), or (m)(1)(i) of this section (regarding certain allocations that are disregarded or not taken into account for purposes of the fractions rule until an actual allocation is made) causes the partnership to violate the fractions rule, the partnership ordinarily is treated as violating the fractions rule only for the taxable year of the actual allocation and subsequent taxable years. For purposes of applying the fractions rule, the term PARTNERSHIP AGREEMENT is defined in accordance with section 1.704-1(b)(2)(ii)(h), and informal understandings are considered part of the partnership agreement in appropriate circumstances. See paragraph (k) of this section for rules relating to changes in the partners’ interests and de minimis exceptions to the fractions rule.”).
1198 Treas. Reg. § 1.514(c)-2(b)(2)(ii).
1199 Treas. Reg. § 1.514(c)-2(b)(1)(i).
For the partnership taxable year for which that partner’s percentage share of overall partnership loss will be the smallest.\textsuperscript{1200}

v) **Overall Partnership Income and Overall Partnership Loss.**

Overall partnership income is the amount by which –

- The aggregate items (“book” items) of partnership income and gain for the taxable year exceed
- The aggregate items (“book” items) of partnership loss and deduction for the taxable year.\textsuperscript{1201}

Overall partnership loss is the amount by which –

- The aggregate items (“book” items) of partnership loss and deduction for the taxable year exceed
- The aggregate items (“book” items) of partnership income and gain for the taxable year.\textsuperscript{1202}

Overall partnership income and overall partnership loss are defined in terms of items that increase or decrease capital accounts (“book” items). Partnership items that are included in computing overall partnership income or loss are those items of income, gain, loss, and deduction (including expenditures described in Section 705(a)(2)(B)) that increase or decrease the partners’ capital accounts under Treasury Regulations Section 1.704-1(b)(2)(iv).\textsuperscript{1203} This excludes tax items that are allocated only under the tax rules governing allocations of tax items attributable to contributed property (Section 704(c)(1)(A)).\textsuperscript{1204}

\textsuperscript{1200}Treas. Reg. § 1.514(c)-2(c)(2).
\textsuperscript{1201}Treas. Reg. § 1.514(c)-2(c)(1).
\textsuperscript{1202}Id.
\textsuperscript{1203}Treas. Reg. § 1.514(c)-2(b)(1)(ii).
\textsuperscript{1204}Treas. Reg. § 1.514(c)-2(c)(1)(i) (“Tax items allocable pursuant to section 704(c) or section 1.704-1(b)(2)(iv)(f)(4) are not included in computing overall partnership income or loss. Nonetheless, allocations pursuant to section 704(c) or section 1.704-1(b)(2)(iv)(f)(4) may be relevant in determining that this section is being applied in a manner that is inconsistent with the fractions rule.”).
vi) Reasonable Guaranteed Payments and Reasonable Preferred Returns.

Payments on capital and certain other payments to qualified organizations may be structured as guaranteed payments. Only the income element of a guaranteed payment to a qualified organization is considered in applying the fractions rule. A guaranteed payment to a qualified organization generally is not treated as an item of partnership loss or deduction in computing overall partnership income or loss. The income that a qualified organization may receive or accrue with respect to a guaranteed payment is treated as an allocable share of overall partnership income or loss for purposes of the fractions rule.\(^{1205}\)

A special exclusion permits reasonable preferred returns for capital or services and reasonable guaranteed payments for capital and services without violating the fractions rule. The reasonable preferred return or reasonable guaranteed payment must be set forth in a binding, written partnership agreement.\(^{1206}\)

Items of income (including items of gross income) and gain may be allocated to a partner with respect to a current or cumulative reasonable preferred return for capital without violating the fractions rule. These reasonable preferred returns are disregarded in computing overall partnership income or loss in determining whether the fractions rule is satisfied. Those items comprising the reasonable preferred allocation, when a partnership agreement contains a reasonable preferred return with an allocation of what would otherwise be overall partnership income, are disregarded in computing overall partnership income for purposes of the fractions rule. Items of income for this purpose include allocations of minimum gain attributable to nonrecourse liability (or partner nonrecourse debt) the proceeds of which are distributed to the partner as a reasonable preferred return.\(^{1207}\)

A current or cumulative reasonable guaranteed payment to a qualified organization for capital or services is treated as an item of deduction in computing overall partnership income or loss in applying the fractions rule. The income allocation to the qualified organization receiving the guaranteed payment is ignored in applying the fractions rule. The income that the qualified organization may receive or accrue from the current or cumulative reasonable guaranteed payment is

---

\(^{1205}\) Treas. Reg. § 1.514(c)-2(c)(1)(ii).
\(^{1206}\) Treas. Reg. § 1.514(c)-2(d)(1).
\(^{1207}\) Treas. Reg. § 1.514(c)-2(d)(1), (2).
not treated as an allocable share of overall partnership income or loss in applying
the fractions rule.\footnote{1208}

The guaranteed payment for services meets the standard of a reasonable
guaranteed payment only to the extent that the amount of the payment is reasona-
ble under Treasury Regulations Section 1.162-7 (relating to the deduction of
compensation for personal services).\footnote{1209}

A preferred return or guaranteed payment for capital is reasonable only to
the extent that the return is computed, with respect to “unreturned capital,” at a
rate that is “commercially reasonable” based on the relevant facts and circum-
stances.\footnote{1210}

Treasury Regulations provide a safe harbor for reasonable guaranteed
payments on capital. The safe harbor is sufficiently powerful that many partne-
ships seek to adhere to this safe harbor. The safe harbor provides:

\begin{quote}
a rate is deemed to be commercially reasonable if it is no greater than
four percentage points more than, or if it is no greater than 150 percent
of, the highest long-term applicable federal rate (AFR) within the meaning
of section 1274(d), for the month the partner’s right to a preferred return
or guaranteed payment is first established or for any month in the partner-
ship taxable year for which the return or payment on capital is computed.
A rate in excess of the rates described in the preceding sentence may be
commercially reasonable, based on the relevant facts and circumstan-
ces.\footnote{1211}
\end{quote}

Treasury Regulations have a straight-forward and acceptable definition of
“unreturned capital.” “Unreturned capital,” for purposes of this test, means the
excess of –

\footnote{1208} Treas. Reg. § 1.1514(c)-2(d)(3) (the treatment of a guaranteed payment as
reasonable for purposes of I.R.C. § 514(c)(9)(E) does not affect its possible char-
acterization as unrelated business taxable income under other provisions.).
\footnote{1209} Treas. Reg. § 1.1514(c)-2(d)(3) (“In any event the allowance for the compen-
sation paid may not exceed what is reasonable under all the circumstances. It
is, in general, just to assume that reasonable and true compensation is only such
amount as would ordinarily be paid for like services by like enterprises under like
circumstances. The circumstances to be taken into consideration are those existing
at the date when the contract for services was made, not those existing at the date
when the contract is questioned.”)
\footnote{1210} Treas. Reg. § 1.1514(c)-2(c)(1).
\footnote{1211} Treas. Reg. § 1.1514(c)-2(d)(4)(ii).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- The amount of money and the fair market value of property contributed by the partner to the partnership (net of liabilities assumed, or taken subject to, by the partnership); over

- The amount of money and the fair market value of property (net of liabilities assumed, or taken subject to, by the partner) distributed by the partnership to the partner as a return of capital.¹²¹²

Determining whether a distribution is a distribution of profits or capital can be an unenviable task. Money is money. A distribution of money normally is not identified as a capital distribution or a profits distribution. You might infer that a particular distribution is a return of capital distribution if the distribution reduces Adjusted Capital Contribution. Merely reducing Capital Accounts provides no guidance at all. All distributions reduce Capital Account. All relevant facts and circumstances are taken into account in determining whether a distribution constitutes a return of capital.¹²¹³ The designation of distributions in a written partnership agreement as a return of capital generally will be respected in determining whether a distribution constitutes a return of capital, so long as the designation is economically reasonable.¹²¹⁴

A special rule limits the deductibility of guaranteed payments to a qualified organization until paid in cash when the partnership has taken advantage of the safe harbor for reasonable guaranteed payments.¹²¹⁵

Items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with re-

¹²¹² Treas. Reg. § 1.514(c)-2(d)(5)(i). See Treas. Reg. § 1.514(c)-2(d)(5)(ii) (“Return of capital. In determining whether a distribution constitutes a return of capital, all relevant facts and circumstances are taken into account. However, the designation of distributions in a written partnership agreement generally will be respected in determining whether a distribution constitutes a return of capital, so long as the designation is economically reasonable.”).

¹²¹³ Treas. Reg. § 1.514(c)-2(d)(5)(ii).

¹²¹⁴ Id.

¹²¹⁵ Treas. Reg. § 1.514(c)-2(d)(6)(ii) (“Reasonable guaranteed payments may be deducted only when paid in cash. If a partnership that avails itself of paragraph (d)(3) of this section would otherwise be required (by virtue of its method of accounting) to deduct a reasonable guaranteed payment to a qualified organization earlier than the taxable year in which it is paid in cash, the partnership must delay the deduction of the guaranteed payment until the taxable year it is paid in cash. For purposes of this paragraph (d)(6)(ii), a guaranteed payment that is paid in cash on or before the due date (not including extensions) for filing the partnership’s return for a taxable year may be treated as paid in that prior taxable year.”).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

spect to a reasonable preferred return for capital are generally disregarded for purposes of the fractions rule. Treasury Regulations provide further limitations on the amount of reasonable preferred returns on capital that are disregarded for purposes of the fractions rule.\textsuperscript{1216}

vii) Chargeback Allocations.

Chargeback allocations are generally ignored when computing allocations of overall income and overall loss in applying the fractions rule. These chargeback allocations are disregarded in computing overall partnership income or loss for purposes of the fractions rule:

- Allocations of what would otherwise be overall partnership income that may be made to charge back (that is, to reverse) prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization, and allocations of what would otherwise be overall partnership loss that may be made to charge back prior disproportionately small allocations of overall partnership income (or part of the overall partnership income) to a qualified organization.\textsuperscript{1217}

\textsuperscript{1216}Treas. Reg. § 1.514(c)-2(d)(6). Treasury Regulations provide:

(i) Limitation on allocations of income with respect to reasonable preferred returns for capital. Items of income and gain (or part of what would otherwise be overall partnership income) that may be allocated to a partner in a taxable year with respect to a reasonable preferred return for capital are disregarded for purposes of the fractions rule only to the extent the allocable amount will not exceed –

(A) The aggregate of the amount that has been distributed to the partner as a reasonable preferred return for the taxable year of the allocation and prior taxable years, on or before the due date (not including extensions) for filing the partnership’s return for the taxable year of the allocation; minus

(B) The aggregate amount of corresponding income and gain (and what would otherwise be overall partnership income) allocated to the partner in all prior years.

Treas. Reg. § 1.512(c)-2(d)(6)(i).

\textsuperscript{1217}Treas. Reg. § 1.514(c)-2(e)(2) (“Disproportionate allocations (i) In general. To qualify under paragraph (e)(1)(i) of this section, prior disproportionate allocations may be reversed in full or in part, and in any order, but must be reversed in the same ratio as originally made. A prior allocation is disproportionately large if the qualified organization’s percentage share of that allocation exceeds (footnote continued on the next page)
its fractions rule percentage. A prior allocation is disproportionately small if the qualified organization’s percentage share of that allocation is less than its fractions rule percentage. However, a prior allocation (or allocations) is not considered disproportionate unless the balance of the overall partnership income or loss for the taxable year of the allocation is allocated in a manner that would independently satisfy the fractions rule. (ii) Limitation on chargebacks of partial allocations. Except in the case of a chargeback allocation pursuant to paragraph (e)(4) of this section, and except as otherwise provided by the Internal Revenue Service by revenue ruling, revenue procedure, or, on a case-by-case basis, by letter ruling, paragraph (e)(1)(i) of this section applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.”); Treas. Reg. § 1.514(c)-2(c)(2)(ii) (“Limitation on chargebacks of partial allocations. Except in the case of a chargeback allocation pursuant to paragraph (e)(4) of this section, and except as otherwise provided by the Internal Revenue Service by revenue ruling, revenue procedure, or, on a case-by-case basis, by letter ruling, paragraph (e)(1)(i) of this section applies to a chargeback of an allocation of part of the overall partnership income or loss only if that part consists of a pro rata portion of each item of partnership income, gain, loss, and deduction (other than nonrecourse deductions, as well as partner nonrecourse deductions and compensating allocations) that is included in computing overall partnership income or loss.”).

Treas. Reg. § 1.514(c)-2(c)(1)(ii). Treas. Reg. § 1.514(c)-2(c)(3) (“Minimum gain chargebacks attributable to nonrecourse deductions. Commencing with the first taxable year of the partnership in which a minimum gain chargeback (or partner nonrecourse debt minimum gain chargeback) occurs, a chargeback to a partner is attributable to nonrecourse deductions (or separately, on a debt-by-debt basis, to partner nonrecourse deductions) in the same proportion that the partner’s percentage share of the partnership minimum gain (or separately, on a debt-by-debt basis, the partner nonrecourse debt minimum gain) at the end of the immediately preceding taxable year is attributable to nonrecourse deductions (or partner nonrecourse deductions). The partnership must determine the extent to which a partner’s percentage share of the partnership minimum gain (or partner nonrecourse debt minimum gain) is attributable to deductions in a reasonable and consistent manner. For example, in those cases in which none of the exceptions con-
Allocations of income or gain that may be made to a partner under a minimum gain chargeback attributable to prior allocations of partner nonrecourse deductions to the partner and allocations of income or gain that may be made to other partners to charge back compensating allocations of other losses, deductions, or Section 705(a)(2)(B) expenditures to the other partners.\textsuperscript{1219}

\textsuperscript{1219}Treas. Reg. § 1.514(c)-2(e)(1)(iii). Extensive additional rules contained in Treas. Reg. § 1.514(c)-2(e)(3), (4) provide additional qualifications. Treas. Reg. § 1.514(c)-2(e)(3) provides:

(3) Minimum gain chargebacks attributable to nonrecourse deductions. Commencing with the first taxable year of the partnership in which a minimum gain chargeback (or partner nonrecourse debt minimum gain chargeback) occurs, a chargeback to a partner is attributable to nonrecourse deductions (or separately, on a debt-by-debt basis, to partner nonrecourse deductions) in the same proportion that the partner’s percentage share of the partnership minimum gain (or separately, on a debt-by-debt basis, the partner nonrecourse debt minimum gain) at the end of the immediately preceding taxable year is attributable to nonrecourse deductions (or partner nonrecourse deductions). The partnership must determine the extent to which a partner’s percentage share of the partnership minimum gain (or partner nonrecourse debt minimum gain) is attributable to deductions in a reasonable and consistent manner. For example, in those cases in which none of the exceptions contained in section 1.704-2(f)(2) through (5) are relevant, a partner’s percentage share of the partnership minimum gain (or partner nonrecourse debt minimum gain) is attributable to nonrecourse deductions in the same ratio that – (i) The aggregate amount of the nonrecourse deductions previously allocated to the partner but not charged back in prior taxable years; bears to (ii) The sum of the amount described in paragraph (e)(3)(i) of this section, plus the aggregate amount of distributions previously made to the partner of proceeds of a nonrecourse liability allocable to an increase in partnership minimum gain but not charged back in prior taxable years.

103
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING PARTNERSHIP AND LLC AGREEMENTS AND SOME BASIC ISSUES IN DRAFTING REAL ESTATE PARTNERSHIP AND LLC AGREEMENTS

- Allocations of items of income or gain that may be made to a partner under a qualified income offset.\textsuperscript{1220}

- Allocations made in taxable years beginning on or after January 1, 2002, that are mandated by statute or regulation other than subchapter K of chapter 1 of the Internal Revenue Code and the regulations thereunder.\textsuperscript{1221}

Allocations of income and gain that may be made under a provision that charges back minimum gain attributable to the distribution of proceeds of a nonrecourse liability (or a partner nonrecourse debt) are taken into account for purposes of the fractions rule only to the extent an allocation is made.\textsuperscript{1222}

Allocations of items of income or gain that (in accordance with Treasury Regulations Section 1.704-2(f)(1) [the minimum gain chargeback requirement])\textsuperscript{1223} may be made to a partner under a minimum gain chargeback attributable to the distribution of proceeds of a nonrecourse liability are disregarded in computing overall partnership income or loss for purposes of the fractions rule to the extent that the allocations (subject to the requirements of Treasury Regulations Section 1.514(c)-2(e)(2)\textsuperscript{1224}) also charge back prior disproportionately large allocations of overall partnership loss (or part of the overall partnership loss) to a qualified organization. This exception applies only to the extent that –

- The disproportionately large allocation consisted of
- Depreciation from
- Real property (other than items of nonrecourse deduction or partner nonrecourse deduction) that subsequently was used to secure the nonrecourse liability providing the distributed proceeds, and
- Only if those proceeds were distributed as a return of capital and in the same proportion as the disproportionately large allocation.\textsuperscript{1225}

\textsuperscript{1220} Treas. Reg. § 1.514(c)-2(e)(1)(iv).
\textsuperscript{1221} Treas. Reg. § 1.514(c)-2(e)(1)(v).
\textsuperscript{1222} Treas. Reg. § 1.514(c)-2(e)(4)(i).
\textsuperscript{1223} See Treas. Reg. § 1.704-2(f)(1) (“Minimum Gain Chargeback Requirement (1) In general. If there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies and each partner must be allocated items of partnership income and gain for that year equal to that partner’s share of the net decrease in partnership minimum gain (within the meaning of paragraph (g)(2)).”).
\textsuperscript{1224} See Treas. Reg. § 1.514(c)-2(e)(2).
\textsuperscript{1225} Treas. Reg. § 1.514(c)-2(e)(2)(ii).
viii) **Exclusion Of Reasonable Partner-Specific Items Of Deduction Or Loss.**

Certain partner-specific expenditures may be allocated to the partners to whom those expenditures are attributable. These partner-specific expenditures may be excluded from overall partnership income and loss under the fractions rule. The exclusion depends on the special allocation of these partner-specific expenditures to the partners to whom they are attributable. These partner-specific expenditures are disregarded in computing overall partnership income or loss for purposes of the fractions rule (if these expenditures are allocated to the partners to whom they are attributable):

- Expenditures for additional record-keeping and accounting incurred in connection with the transfer of a partnership interest (including expenditures incurred in computing basis adjustments under Section 743(b));
- Additional administrative costs that result from having a foreign partner;
- State and local taxes or expenditures relating to those taxes; and
- Expenditures designated by the Internal Revenue Service by revenue ruling or revenue procedure, or, on a case-by-case basis, by letter ruling.\(^\text{1226}\)

ix) **Exclusion of Unlikely Losses and Deductions.**

A loss or deduction item may be possible, but it may have a low probability of occurring. Treasury Regulations recognize a special exception for unlikely loss items in applying the fractions rule. The unlikely loss items are excluded from the determination of overall “book” partnership income or loss. This exception does not apply to nonrecourse deductions. The fractions rule requires that the allocation of “book” items to any qualified organization partner cannot result in the partner having a share of the overall “book” partnership income for any taxable year greater than the partner’s share of the overall partnership “book” loss for the taxable year for which the partner’s loss share will be the smallest. The fractions rule disregards (in computing overall partnership income or loss) unlikely losses or deductions (other than items of nonrecourse deduction) that are specially allocated to partners that bear the economic burden of those losses or deductions.

---

\(^{1226}\) Treas. Reg. § 1.514(c)-2(f).
This exception applies only so long as a principal purpose of the allocation is not tax avoidance. \footnote{1227}

Exclusion requires that the loss or deduction must have a low likelihood of occurring. Treasury Regulations do not clarify precisely what it means to have a low likelihood of occurring – or precisely how one goes about determining the likelihood of a future deduction or loss. The determination takes into account all relevant facts, circumstances, and information available to the partners (including \textit{bona fide} financial projections).

Examples of possible unlikely losses or deductions include:

\begin{itemize}
  \item Tort and other third-party litigation that give rise to unforeseen liabilities in excess of reasonable insurance coverage;
  \item Unanticipated labor strikes;
  \item Unusual delays in securing required permits or licenses;
  \item Abnormal weather conditions (considering the season and the job site);
  \item Significant delays in leasing property due to an unanticipated severe economic downturn in the geographic area;
  \item Unanticipated cost overruns; and
  \item The discovery of environmental conditions that require remediation. \footnote{1228}
\end{itemize}

We could debate many of these items. How unanticipated must labor strikes be to be “unanticipated” for this purpose? Some builders might suggest that labor strikes always are anticipated. How unusual must “unusual” delays in securing required permits or licenses to be considered unusual? Some builders would contend that these delays always are anticipated. How abnormal must abnormal weather conditions be to be considered abnormal? How unanticipated must cost overruns be to be considered unanticipated? One might assert that cost overruns always should be anticipated. Each of these items should be subjected to a “low probability” filter for purposes of the fractions rule.

Treasury Regulations clarify that no inference should be drawn as to whether a loss or deduction is unlikely from the fact that the partnership agreement includes a provision for allocating that loss or deduction. \footnote{1229}
x) Provisions Preventing Deficit Capital Account Balances.

The alternate test of economic effect creates what in effect is a stop loss arrangement when a partner’s capital account has been reduced to zero and that partner does not have liability to restore any deficit balance in his capital account. This arrangement might cause disqualified allocations in the absence of a special exception in Treasury Regulations. The fractions rule generally disregards an allocation when it is unlikely that the allocation will be made under the provision during the life of the partnership. The fractions rule disregards –

- A provision in your partnership agreement that allocates items of loss or deduction away from a qualified organization partner
- In instances when allocating those items to the qualified organization would cause or increase a deficit balance in its capital account that the qualified organization is not obligated to restore (in taxable years of the partnership in which none of these allocations are made under the provision).

This exception for provisions preventing deficit capital account balances applies only if –

- At the time the provision becomes part of the partnership agreement,
- All relevant facts, circumstances, and information (including bona fide financial projections) available to the partners reasonably indicate that
- An allocation is unlikely to be made under the provision during the life of the partnership.

The use of “unlikely” imparts an event with a probability of less than 50%. This term suggests that the exception will apply if an allocation under the stop loss provision is less than 50%. This requires a subjective determination of future probabilities. The size of the allocation apparently is not considered under this exception. The exception is dependent on the allocation being unlikely, but the exception does not consider the expected value of the allocation.

---

1230 See discussion of the alternate test for economic effect in the text at note 1049.
1231 Within the meaning of Treas. Reg. § 1.704-1(b)(2)(ii)(b) or (d).
1232 Treas. Reg. § 1.514(c)-2(h).
1233 Treas. Reg. § 1.514(c)-2(h).
 xi) Exception for partner nonrecourse deductions

Partner nonrecourse deductions are disregarded in applying the fractions rule until the partner nonrecourse deductions are actually allocated.\textsuperscript{1234}\textsuperscript{1235} Items of partner nonrecourse deduction that may be allocated to a partner under the rules governing partner nonrecourse deductions, and compensating allocations of other items of loss, deduction, and Section 705(a)(2)(B) expenditures that may be allocated to other partners, are not taken into account for purposes of the fractions rule until the taxable years in which they are allocated.\textsuperscript{1236}

The fractions rule disregards a violation of the fractions rule if it arises because –

- An allocation of partner nonrecourse deductions to a qualified organization
- That is not motivated by tax avoidance
- Reduces
- Another qualified organization’s fractions rule percentage (below what it would have been absent the allocation of the partner nonrecourse deductions).\textsuperscript{1237}

 xii) Changes In Partnership Allocations Arising From A Change In The Partners’ Interests.

A qualified organization that acquires a partnership interest from another qualified organization is treated as a continuation of the prior qualified organization partner for purposes of applying the fractions rule.\textsuperscript{1238} This convention applies to the extent of that acquired interest.\textsuperscript{1239}

Treasury Regulations warn that the IRS will closely scrutinize changes in partnership allocations that result from other transfers or shifts of partnership interests.\textsuperscript{1240} This scrutiny will seek to determine whether the transfer or shift stems from a prior agreement, understanding, or plan or could otherwise be expected given the structure of the transaction.\textsuperscript{1241} Changes in partnership allocations that

\textsuperscript{1234} Treas. Reg. § 1.514(c)-2(j)(1).
\textsuperscript{1235} See Treas. Reg. § 1.704-2. See discussion at note 888.
\textsuperscript{1236} Id.
\textsuperscript{1237} Treas. Reg. § 1.514(c)-2(j)(2).
\textsuperscript{1238} Treas. Reg. § 1.514(c)-2(k)(1).
\textsuperscript{1239} Id.
\textsuperscript{1240} Id.
\textsuperscript{1241} Id.
result from other transfers or shifts of partnership interests generally will be taken into account only in determining whether the partnership satisfies the fractions rule in the taxable year of the change and subsequent taxable years.\textsuperscript{1242}

xiii) \textbf{De minimis Interest Rule.}

Qualified organizations may own only small interests in a partnership with nonqualified allocations and debt-financed property. The rule that characterizes partnership property as debt financed property in the absence of qualified allocations (Section 514(c)(9)(B)(vi)) does not apply to a partnership if –

- Qualified organizations do not hold, in the aggregate, interests of greater than five percent in the capital or profits of the partnership; and
- Taxable partners own substantial interests in the partnership through which they participate in the partnership on substantially the same terms as the qualified organization partners.\textsuperscript{1243}

xiv) \textbf{De minimis Allocations.}

A qualified organization’s fractions rule percentage of the partnership’s items of loss and deduction (other than nonrecourse and partner nonrecourse deductions) that are allocated away from the qualified organization and to other partners in any taxable year are treated as having been allocated to the qualified organization for purposes of the fractions rule if –

- The allocation was neither planned nor motivated by tax avoidance; and
- The total amount of those items of partnership loss or deduction is less than both –
  - One percent of the partnership’s aggregate items of gross loss and deduction for the taxable year; and
  - $50,000.\textsuperscript{1244}

xv) \textbf{Anti-Abuse Rule.}

The purpose of the fractions rule is to prevent tax avoidance by limiting the permanent or temporary transfer of tax benefits from tax-exempt partners to

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{1242} Id.
\item \textsuperscript{1243} Treas. Reg. § 1.514(c)-2(k)(2).
\item \textsuperscript{1244} Treas. Reg. § 1.514(c)-2(k)(3).
\end{enumerate}
\end{footnotesize}
taxable partners, whether by directing income or gain to tax-exempt partners, by directing losses, deductions, or credits to taxable partners, or by some other similar manner. An anti-abuse rule provides that the fractions rule may not be applied in a manner that is inconsistent with the purpose of the fractions rule. 1245

150. Section 168(h)(6).

Section 168(h)(6) increases the depreciable life of a portion of depreciable real property to forty years (technically, resulting in the property being treated as “tax-exempt use property”) if the real property is owned by a partnership. This depends on the partnership having one or more tax-exempt entities as partners and any allocation to the tax-exempt entity of partnership items is not a qualified allocation. A “qualified allocation” means any allocation to a tax-exempt entity which—(i) is consistent with such entity’s being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and (ii) has substantial economic effect. 1246 For purposes of this subparagraph, items allocated under section 704(c) shall not be taken into account. 1247 The apparent purpose of Section 168(h)(6) is to prevent the partnership from improperly transferring tax benefits from tax-exempt partners that cannot use them to taxable partners.

151. Section 470.

Section 470, added in 2004, was designed to address abusive leasing transactions known as “sale-in, lease-out” or SILO transactions. 1248 This provision, however, is so expansive that it captures many thousands of nonabusive partnership transactions when partnerships contain tax-exempt organizations as partners and property is treated as tax-exempt use property by virtue of the operation of Section 168(h)(6). Section 470 is potentially a serious concern for any partnership that contains tax-exempt entities and taxable entities (including indirect partners through pass-through entities). Section 470 can substantially burden

1245 Treas. Reg. § 1.514(c)-2(k)(4).
1246 Within the meaning of I.R.C. § 704(b)(2).
the ability of taxable partners to deduct losses from partnership property. This is a major issue for the draftsman of a partnership agreement where the partnership includes both taxable and tax-exempt partners. Section 470 currently is a terribly troubled area of the tax law. With the effectiveness of Section 470 pending, seriously consider satisfying the fractions rule if your partnership agreement includes both taxable and tax-exempt partners. This requires drafting a partnership agreement that satisfies the technical requirements of “substantial economic effect.”

Section 470 provides that a “tax-exempt use loss” for any taxable year is not allowed.\textsuperscript{1249} “Tax exempt use loss” means, with respect to any taxable year, the amount (if any) by which (i) the sum of the aggregate deductions (other than interest) directly allocable to tax-exempt use property, plus (ii) the aggregate deductions for interest properly allocable to the property, exceed (iii) the aggregate income from the property.\textsuperscript{1250} Any disallowed loss is treated as a deduction with respect to the property in the next taxable year.\textsuperscript{1251} Section 470 applies on a property-by-property basis. The effect of Section 470 is to suspend the deductibility of tax losses from the particular property until the losses are offset with net income from the property. This imposes on the partnership the heavy accounting burden of identifying and segregating the tax items from each of its properties. Section 470 will impose heavy burdens on a partnership to seek information from direct and indirect partners.

“Tax-exempt use property” is defined under the rules of Section 168(h).\textsuperscript{1252} This generally applies to property that is leased to a tax-exempt entity. Section 168(h)(6), as discussed above, expands “tax-exempt use property” to partnership property when the partnership has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and any allocation to the tax-exempt entity of partnership items is not a qualified allocation. The tax-exempt entity’s proportionate share of the property generally is treated as tax-exempt use property.

\textsuperscript{1249} I.R.C. § 470(a).
\textsuperscript{1250} I.R.C. §470(c)(1).
\textsuperscript{1251} I.R.C. § 470(b).
\textsuperscript{1252} I.R.C. § 470(c)(2) (“The term ‘tax-exempt use property’ has the meaning given to such term by section 168(h), except that such section shall be applied—(A) without regard to paragraphs (1)(C) and (3) thereof, and (B) as if property described in – (i) section 167(f)(1)(B), (ii) section 167(f)(2), and (iii) section 197 intangible, were tangible property. Such term shall not include property which would (but for this sentence) be tax-exempt use property solely by reason of section 168(h)(6) if any credit is allowable under section 42 or 47 with respect to such property.”).
As this article goes to press, there is substantial discontent with the application of Section 470 to partnerships and proposed revisions are pending in Congress. Notice 2005-29 provides temporary transition relief under which: “In the case of partnerships and pass-thru entities described in § 168(h)(6)(E), for taxable years that begin before January 1, 2005, the Service will not apply § 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of § 168(h)(6).” Notice 2006-2 further extends this relief: “In the case of partnerships and pass-thru entities described in § 168(h)(6)(E), for taxable years that begin before January 1, 2006, the Service will not apply § 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of § 168(h)(6). Abusive transactions involving partnerships and other pass-thru entities remain subject to challenge by the Service under other provisions of the tax law.” Notice 2007...

The issues are articulately described in a letter to the Honorable William M. Thomas, Chairman, House Committee on Ways and Means, the Honorable Charles E. Grassley, Chairman, Senate Committee on Finance, the Honorable Charles B. Rangel, Ranking Member, House Committee on Ways and Means, and the Honorable Max S. Baucus, Ranking Member, Senate Committee on Finance, dated July 18, 2005, from David P. Hariton, Chair, New York State Bar Association Section on Taxation, 2005 TNT 137-24 (July 18, 2005).

A letter from the Taxation Section of the New York State Bar Association argues:

In view of the foregoing, we believe that Congress should scale back the partnership aspect of Section 470 to a provision that is more targeted to potential SILO-like transactions. Set forth in Exhibit A hereto is our proposed legislative solution. Our proposal would eliminate the partnership aspect of Section 470 in its current form by removing the cross-reference to the partnership aspect of Section 168(h). In its place, our proposal would add a provision applying Section 470 only to partnership transactions that embody the two key features of a SILO transaction. Those features would be (1) the use of partnership property by a tax-exempt partner and (2) a disproportionately large share of the tax benefits from the property being allocated to taxable partners. This provision uses objective criteria [that] should enable the participants in typical partnership transactions to quickly and easily conclude that such transactions are not subject to Section 470, while at the same time preventing abusive transactions. [13: 13 Note that the provision should apply to the transaction described in the ABA Letter, since (i) the subject property is operated (footnote continued on the next page)
by the municipality pursuant to a management contract and (ii) a disproportionately large share of the tax benefits from the property is allocated to the taxable person.] It would be possible to list additional features in defining the class of partnership transactions subject to Section 470, but we do not believe that is necessary for the provision to have a reasonably limited scope. [14: The additional features that might be added include (i) features that reduce the benefits and burdens of ownership as to the taxable partners (for example, fixed price put options, defeasance arrangements and nonrecourse financing), (ii) an implicit “fee” to the tax-exempt partner and (iii) a lack of meaningful economic profit motive on the part of the taxable partners.] However, in recognition of the possibility that some legitimate partnership transactions might be covered by the provision, our proposal allows the IRS to waive the application of the provision if it determines that to be appropriate in any particular case. Our proposal also includes a grant of regulatory authority to the Treasury to interpret the provision and expand its reach if that becomes necessary to prevent abuses (including through the issuance of notices rather than regulations).

We note that some commentators have suggested retaining the partnership aspect of Section 470 but adding exceptions for partnership transactions that are not abusive. We would counsel against that approach. First, as previously mentioned, the need for any sort of rule to prevent “synthetic SILO” partnerships appears to be fairly limited, so only a very targeted rule would seem to be warranted. Second, the approach of covering most partnerships but then providing specific exceptions for legitimate transactions would force taxpayers and the government to apply what would inevitably be complex law defining the exceptions. In particular, creating an exception based upon the “fractions rule” in Section 514(c)(9)(E), as some have suggested, would involve enormous complexity and create very significant commercial problems. [15: 15 A proposal along these lines can be found in the letter of the Real Estate Roundtable dated March 4, 2005 captioned “Section 470 and Real Estate Partnerships”.] As the Tax Section has stated in three separate reports, the fractions rule is deeply flawed even as applied in its original context of leveraged real estate partnerships with tax-exempt organization partners. [16: Our most recent comments, including recommended reforms, were provided in “Report on Section 514(c)(9)(E) Concerning Investments in Leveraged Real Estate Partnerships” dated Feb. 14, 1997 (reproduced at 97 TNT 34-39 ).] Extending the fractions rule more broadly for Section 470 purposes would only compound the problems associated with the (footnote continued on the next page)
extends by one year the transition relief in Notice 2006-2 and Notice 2005-29 for taxable years beginning before January 1, 2006. Further, Notice 2007-4 clarifies that the IRS will not apply Section 470 to disallow losses associated with property that is treated as tax-exempt use property solely as a result of the application of Section 168(h)(6) in the case of partnerships and pass-thru entities described in Section 168(h)(6)(E), for taxable years beginning before January 1, 2007. Abusive transactions involving partnerships and other pass-thru entities remain subject to challenge by the IRS under other provisions of the tax law.

On September 29, 2006, the Tax Technical Corrections Act of 2006 was introduced in Congress. Action on this legislation has been delayed. The legislation in the Tax Technical Corrections Act of 2006, if enacted in its current form, will be effective substantially retroactively, in the case of property treated as tax-exempt use property solely by reason of Section 168(h)(6), to property acquired after March 12, 2004. The Staff of the Joint Committee on Taxation, DESCRIPTION OF THE TAX TECHNICAL CORRECTIONS ACT OF 2006 (October 2, 2006, J CX–48-06), provides that Congress does not intend that the effective date of the legislation contained in the Tax Technical Corrections Act of 2006 supersedes the rules set forth in Notice 2006-2 and Notice 2005-29, with respect to the application of Section 470 in the case of partnerships and other pass-thru entities, for taxable years of these entities beginning in 2005 and 2004. (This perhaps will be revised to include taxable years beginning in 2006.) Notice 2007-4 provides that the IRS will continue to apply the rules set forth in Notice 2005-29 and Notice 2006-2.

Furthermore, a fractions rule exception would not be nearly broad enough to carve out the many types of ordinary partnership transactions that do not involve SILO-like abuses.

Letter from David Hariton, Chair, Taxation Section, New York State Bar Association, dated July 18, 2005, to the Honorable William M. Thomas, Chairman, House Committee on Ways and Means, the Honorable Charles E. Grassley, Chairman, Senate Committee on Finance, the Honorable Charles B. Rangel, Ranking Member, House Committee on Ways and Means, the Honorable Max S. Baucus, Ranking Member, Senate Committee on Finance, Re: Section 470 Legislation, 2005 TNT 137-24. See also letter from Susan P. Serota, Chair, Section of Taxation, American Bar Association, dated October 31, 2006, to the Honorable Charles E. Grassley, Chairman, Senate Committee on Finance, the Honorable Max S. Baucus, Ranking Member, Senate Committee on Finance, the Honorable William M. Thomas, Chairman, House Committee on Ways and Means, the Honorable Charles B. Rangel, Ranking Member, House Committee on Ways and Means, re: Tax Technical Corrections Act (H.R.6264 and S.4026), 2006 TNT 212-21 (October 31, 2006).
The Tax Technical Corrections Act of 2006 (H.R. 6264) would mitigate the effects of this provision. This bill is not satisfactory to all advisors. The safe harbor described in the proposed legislation would require burdensome information collection by a partnership from its direct and indirect partners. The Joint Committee Description of the Tax Technical Corrections Act of 2006 explains:

The treatment of partnerships under the limitation on deductions allocable to property used by governments or other tax-exempt entities (Act sec. 848). – Code section 470 generally applies loss deferral rules in the case of property leased to tax-exempt entities. The manner of application of section 470 in the case of property owned by a partnership in which a tax-exempt entity is a partner is unclear. The provision provides rules for the application of section 470 in the case of property that is tax-exempt use property solely by virtue of being owned by a partnership with a tax-exempt partner. The provision provides that, generally, if any portion of property is treated as tax-exempt use property by reason of section 168(h)(6), then all of such property is treated as tax-exempt use property under section 470. However, the provision provides that property owned by a partnership is not treated as tax-exempt use property under section 470 if it is not depreciable or amortizable property. In addition, the provision provides that property owned by a partnership is not treated as tax-exempt use property under section 470 if two sets of requirements are met. The requirements relate to (1) availability of funds set aside or under certain arrangements, and (2) certain options to purchase property of the partnership.

Availability of funds

The provision requires that, at all times during the taxable year, no more than the allowable partnership amount of funds be subject to an arrangement, set-aside, or expected set-aside, that is to or for the benefit of any taxable partner or any lender, or is to or for the benefit of any tax-exempt partner, in order to satisfy any obligation of the tax-exempt partner to the partnership, any taxable partner, or any lender. With respect to funds owned by the partnership, the allowable partnership amount is the greater of (a) 20 percent of the sum of the taxable partners’ capital accounts (determined under the rules of section 704(b)) and the taxable partners’ share of recourse liabilities of the partnership (determined under section 752), or (b) 20 percent of the aggregate debt of the partnership. With respect to funds not owned by the partnership, the allowable partnership amount is zero.

For this purpose, an arrangement includes a loan by a tax-exempt partner or the partnership to any taxable partner, the partnership, or any lender, as well as an arrangement described in present-law sec-
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

Section 470(d)(1)(B). [fn2: Arrangements referred to in this section include defeasance arrangements; deposit agreements; letters of credit collateralized with cash or cash equivalents; payment undertaking agreements; prepaid rent (within the meaning of the regulations under section 467); sinking fund arrangements; guaranteed investment contracts; financial guaranty insurance; or any similar arrangements.] The amount subject to an arrangement, or set aside or expected to be set aside, includes the amount of any interest or other income or gain earned on the amount. Amounts are treated as set aside or expected to be set aside only if a reasonable person would conclude that the facts and circumstances indicate that such amounts are set aside or expected to be set aside.

The provision provides an exception for funds set aside or subject to an arrangement on a short-term basis. Under this rule, funds that are set aside, or subject to an arrangement, for a period of less than 12 months are not taken into account in determining whether more than an allowable amount of funds are set aside or subject to an arrangement. All related set asides and arrangements are treated as a single arrangement for this purpose, except as provided in regulations. Thus, for example, a series of multiple set asides or arrangements which combine to exceed the 12-month threshold are not eligible for the exception under the provision. The exception should not be interpreted to permit taxpayers to effectively extend the 12-month threshold by use of separate and fungible set asides or arrangements.

In addition, the provision provides an exception for funds subject to an arrangement, or set aside or expected to be set aside, that bear no connection to the economic relationships between and among the partners and that bear no connection to the economic relationships between the partners and the partnership. Any funds that bear a connection either to the economic relationship between two or more partners or to the economic relationship between the partnership and any partner do not meet the exception and must be taken into account.

With respect to the available funds requirement of the exception for certain leases under present law section 470(d)(1), it is possible that present law might be interpreted to require only that the arrangements and set asides are less than or equal to the allowable amount at a single moment during the lease term. The provision clarifies that the arrangements and set asides must be less than or equal to the allowable amount at all times during the lease term.
No fixed-price purchase option

Under the provision, no tax-exempt partner may have an option to purchase or compel the distribution of partnership property or any direct or indirect interest in the partnership for any stated purchase price or valuation other than the fair market value of the property (as determined at the time of exercise of the option). Similarly, neither the partnership nor any taxable partner may have an option to sell or compel distribution of partnership property or any direct or indirect interest in the partnership to a tax-exempt partner for any stated purchase price or valuation other than the fair market value of the property (as determined at the time of exercise of the option).

The provision provides authority for the Secretary of the Treasury to promulgate regulations under which an option to purchase, sell, or compel distribution of partnership property or a partnership interest for a fair market value determined by a formula does not violate this requirement. The regulation authority applies to formulas under which the fair market value is determined on the basis of objective criteria that are reasonably designed to approximate the fair market value of property at the time of the purchase, sale, or distribution.

Clarification of regulatory authority

The provision clarifies that the present-law regulatory authority granted to the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 470.

The provision provides that the Secretary shall prescribe regulations that provide for the application of section 470 to tiered and other related partnerships. At the discretion of the Secretary, such regulations may permit or require the aggregation of tiered or related partnerships where appropriate for purposes of any or all determinations required under section 470. The regulations may also permit or require the aggregation of partnership property.

The provision clarifies that the Secretary may, by regulation, provide for the treatment of partnership property as tax-exempt use property for purposes of the loss deferral rules of section 470 if such property is used in an arrangement which is inconsistent with the purposes of section 470, regardless of whether the statutory exception is satisfied. The provision provides an illustrative list of factors which may be indicators of a transaction that is inconsistent with the purposes of section 470. None of these factors, by itself, is determinative that a transaction is inconsistent with the purposes of section 470. However, the Secretary may determine
that some combination of one or more of these and other factors results in the treatment of partnership property as tax-exempt use property.

The provision is effective as if included in the provisions of the American Jobs Creation Act of 2004 to which they relate. It is not intended that the provision supersede the rules set forth by the Treasury Department in Notice 2005-29, 2005-13 I.R.B. 796, and Notice 2006-2, 2006-2 I.R.B. 1, with respect to the application of section 470 in the case of partnerships for taxable years of partnerships beginning in 2004 and 2005.1258


Contributors and partnership agreement draftsmen should be keenly aware of situations that can create disguised sales of partnership interests or disguised sales of property contributed by a partner.1259 The disguised sale rules are a chal-

---

1258 Joint Committee on Taxation, Description of the Tax Technical Corrections Act of 2006, 6-8 (JCX-48-06, October 2, 2006).
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

A challenge for many property contributions to partnerships. This section provides merely a brief introduction to the complex disguised sale rules.

a. Covenants.

Contributions of property to your partnership create issues under tax rules governing disguised sales of property or disguised sales of partnership interests.1260 A well-drafted partnership agreement might contain a matrix of partnership covenants designed to avoid disguised sale treatment – and possibly indemnifications if covenants are violated. These covenants, if drafted correctly and observed, could ensure that distributions will meet safe harbor requirements under disguised sale rules. These covenants should address potential disguised sales (under Section 704, 707, and 737). These covenants should include both potential disguised sales of property by a partner to your partnership. These covenants should address potential disguised sales of partnership interests. Partnership covenants might prohibit distributions of contributed property to another partner within a two-year safe harbor provision contained in Treasury Regulations. Drafting these provisions requires comprehensive understanding of the partnership disguised sale rules. They should consider extensive disguised sale Treasury Regulations under Sections 704, 707, and 737.1261

b. Theory.

The basic theory of the disguised sale rules is to tax as sales those transactions that, though structured as contributions and distributions under sections 721 and 731, in substance are sales. The theory of disguised sale rules is to tax as sales transactions that look more like sales than contribution and distribution transactions. The general theory is that when a contribution and related distribution are treated as a disguised sale, the contribution and distribution will be treated as a sale or exchange between the partnership and a person acting in a capacity other than as a member of the partnership for all purposes of the Code. The consideration is transferred to the partner who contributed property. Then only a proportionate portion of the transaction is treated as a disguised sale. The remainder of the transaction is treated as a \textit{bona fide} contribution transaction.

Disguised sales can include transactions that involve nonsimultaneous transfers by a partner to the partnership and then by the partnership of other property or cash to the partner. The Section 707 Treasury Regulations treat the sale as an installment sale occurring on the first transfer. The transferring partner is treat-

1261 At the time when this is written, there are only Proposed Treasury Regulations concerning disguised sales of partnership interests.
ed as if he received an obligation of the partnership as consideration for the property on the date when the partnership acquired ownership of the property, when a partnership interest is transferred to a partner that is part of a disguised sale that occurs subsequent to the partner’s transfer of property to the partnership.

c. **Base Test of Disguised Sale under Section 707.**

The determination of whether a transfer of property by a partner to the partnership and a transfer of money or other consideration by the partnership to the partner constitute a sale (in whole or in part) is made based on all the facts and circumstances in each case. The weight to be given each of the facts and circumstances will depend on the particular case. This makes the facts and circumstances practically impossible to apply with mathematical precision. The test generally looks to the facts and circumstances existing on the date of the earliest of the transfers.\(^{1262}\) Factors are listed in Treasury Regulations, but these factors are generally secondary to presumptions as a matter of practice. These factors are listed in Treasury Regulations:

- That the timing and amount of a subsequent transfer are determinable with reasonable certainty (at the time of an earlier transfer);
- That the transferee has a legally enforceable right to the subsequent transfer;
- That the partner’s right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured;
- That any person has made or is legally obligated to make contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration;
- That any person has loaned or has agreed to lend the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether the lending obligation is subject to contingencies related to the results of partnership operations;
- That the partnership has incurred or is obligated to incur debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt (considering such factors as whether any person has agreed to guarantee or otherwise assume personal liability for that debt);

\(^{1262}\)Treas. Reg. § 1.707-3(b)(1).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- That the partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer (taking into account the income that will be earned from those assets);
- That partnership distributions, allocations or control of partnership operations is designed to undertake an exchange of the burdens and benefits of ownership of property;
- That the transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner’s general and continuing interest in partnership profits; and
- That the partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation but it is likely to become due at such a distant time in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.\textsuperscript{1263}

d. Two-Year Presumptions.

The disguised sale rules under Section 707 operate substantially under presumptions. These presumptions are difficult to overcome. These are the basic presumptions:

- Transfers between a partnership and a partner that are made within two years of each other are presumed to be a sale. This presumption is subject to exceptions for guaranteed payments for capital, reasonable preferred returns or operating cash flow distributions.
- Transfers made more than two years apart are presumed not to be a sale.

The disguised sale Treasury Regulations provide:

\textit{For purposes of this section, if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner (without regard to the order of the transfers), the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale.}\textsuperscript{1264}

\textsuperscript{1263} Treas. Reg. § 1.707-3(b)(2).
\textsuperscript{1264} Treas. Reg. § 1.707-3(c)(1).
The Treasury Regulations contain this presumption favorable to the contributing partner:

For purposes of this section, if a transfer of money or other consideration to a partner by a partnership and the transfer of property to the partnership by that partner are more than two years apart, the transfers are presumed not to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers constitute a sale.\(^{1265}\)

The party against whom the presumption operates, when the general presumption applies, must rebut the presumption by facts and circumstances that clearly overcome the presumption. The party against whom the presumption operates must clearly establish that the presumption should be overcome.

Treasury Regulations impose a special disclosure obligation when reciprocal transfers are made within two years.\(^{1266}\)

The strength of the two-year presumptions is sufficiently strong that a series of safe harbors are critical in overcoming the presumptions. Two of the most important safe harbors permit the partnership to pay reasonable guaranteed payments for capital and reasonable preferred returns without having the payments treated as disguised sale payments. Treasury Regulations have the effect of placing a limit on many of the guaranteed returns and preferred returns that partnerships can pay to partners. Be aware of these limitations in drafting guaranteed payments or preferred returns.

e. Transfers of Encumbered Property to a Partnership.

Be particularly careful when the contributors have incurred indebtedness within two years of the transfer of property to the partnership. A transfer of property subject to a liability often will constitute a taxable disguised sale transaction

\(^{1265}\) Treas. Reg. § 1.707-3(d).

\(^{1266}\) Treas. Reg. § 1.707-3(c)(2) (“(2) Disclosure of transfers made within two years. Disclosure to the Internal Revenue Service in accordance with section 1.707-8 is required if— (i) A partner transfers property to a partnership and the partnership transfers money or other consideration to the partner within a two-year period (without regard to the order of the transfers); (ii) The partner treats the transfers other than as a sale for tax purposes; and (iii) The transfer of money or other consideration to the partner is not presumed to be a guaranteed payment for capital under section 1.707-4(a)(1)(ii), is not a reasonable preferred return within the meaning of section 1.707-4(a)(3), and is not an operating cash flow distribution within the meaning of section 1.707-4(b)(2).”).
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

if the liability is not a qualified liability. A qualified liability is a liability in any of these four categories –

(i) The liability is –

(A) A liability that was incurred by the partner more than two years prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property throughout that two-year period;

(B) A liability that was not incurred in anticipation of the transfer of the property to a partnership, but that was incurred by the partner within the two-year period prior to the earlier of the date the partner agrees in writing to transfer the property or the date the partner transfers the property to the partnership and that has encumbered the transferred property since it was incurred (see paragraph (a)(7) of this section for further rules regarding a liability incurred within two years of a property transfer or of a written agreement to transfer);

(C) A liability that is allocable under the rules of Section 1.163-8T to capital expenditures with respect to the property; or

(D) A liability that was incurred in the ordinary course of the trade or business in which property transferred to the partnership was used or held but only if all the assets related to that trade or business are transferred other than assets that are not material to a continuation of the trade or business; and

(ii) If the liability is a recourse liability, the amount of the liability does not exceed the fair market value of the transferred property (less the amount of any other liabilities that are senior in priority and that either encumber such property or are liabilities described in paragraph (a)(6)(i)(C) or (D) of this Section) at the time of the transfer.\textsuperscript{1267}

A partner may contribute property to a partnership subject to a nonqualified liability. This transaction will not create disguised sale consideration if the transfer of the property and liability to the partnership does not shift the liability to other partners. The partner receives disguised sale consideration only to the extent that the nonqualified liability is transferred to other partners. The liability can be retained by the contributing partner through the partner guaranteeing the debt or retaining liability of the debt if the debt was a recourse liability. The situation

\textsuperscript{1267}Treas. Reg. § 1.707-5(a)(6).
must create circumstances under which the contributing partner bears the ultimate risk of loss of the liability.\footnote{1268}

\textbf{f. Distribution of Refinancing Proceeds.}

The disguised sale rules permit distributions from the proceeds of refinancing to a partner without causing disguised sale gain. These rules permit a contributing partner to extract cash from a fresh refinancing without recognizing disguised sale gain. The Treasury Regulations provide: “if a partner transfers property to a partnership, and the partnership incurs a liability and all or a portion of the proceeds of that liability are allocable under Section 1.163-8T to a transfer of money or other consideration to the partner made within 90 days of incurring the liability, the transfer of money or other consideration to the partner is taken into account only to the extent that the amount of money or the fair market value of the other consideration transferred exceeds that partner’s allocable share of the partnership liability.”\footnote{1269} A partner may receive distributions of the proceeds of debt that is not more than 90 days old if the amount of money distributed to the contributing partner is no greater than the contributing partner’s share of the debt. The key to this provision is that the money distributed to the partner must be less than or equal to the partner’s allocable share of the partnership liability if dis-

\footnote{1268}This is explained in the preamble to Treasury Regulations:

\textit{B. Partner’s Share Of Liability.}

\textit{The final regulations adopt the proposed rule providing that a partner’s share of a recourse liability equals the partner’s share of the liability under section 752 and the corresponding regulations. The final regulations, however, depart from the proposed rule for determining a partner’s share of a nonrecourse liability. The final regulations provide that a partner’s share of a nonrecourse liability is determined by applying the same percentage used to determine the partner’s share of the excess nonrecourse liability under section 1.752-3(a)(3) (the so-called third-tier allocation rule).}

\textit{The final regulations change the proposed rule regarding a partner’s share of a nonrecourse liability in response to comments and in an effort to achieve greater simplicity. The Service and the Treasury did not adopt the nonrecourse debt allocation rules provided in section 752 and the regulations thereunder in their entirety, because this approach would tend to produce an inverse relationship between the gain inherent in the contributed property and the extent to which a disguised sale of the property results from the encumbrance.}


\footnote{1269}Treas. Reg. § 1.707-5(b)(1).
guised sale treatment is to be avoided. A partner can guarantee partnership liabilities in order to avoid disguised sale gain under this provision.

g. **Reimbursement of Preformation Expenses.**

Consider the exception to the disguised sale rules for reimbursement of preformation expenses. The preformation expense safe harbor permits the partnership to make cash payments to a contributing partner without the contributing partner recognizing taxable gain from a disguised sale. This exception can be used to advantage to permit contributing partners partially to cash out at the time of their contribution to the partnership. The preamble to Treasury Regulations explains the exception:

_The proposed regulations provide that transfers made to reimburse partners for certain capital expenditures incurred within one year prior to contributing property to a partnership are excepted from the rules of section 1.707-3(a) of the proposed regulations. The final regulations extend this exception to expenditures incurred within two years of the transfer by the partner to the partnership. The final regulations retain the proposed rule that reimbursements of capital expenditures are excepted from disguised sale treatment if they do not exceed 20 percent of the fair market value of the property. In the case of a reimbursement that exceeds 20 percent of the value, the final regulations allow the reimbursement to qualify for this exception to the extent of 20 percent of value. Under an alternative rule included in the final regulations, 100 percent of the reimbursements of capital expenditures are excepted from disguised sale treatment if the value of the property contributed by the partner does not exceed 120 percent of the partner’s basis in the contributed property._

Payments to a contributing partner are not treated as disguised sale payments to the extent that the payments to the contributing partner are made to reimburse the partner for, and do not exceed the amount of, capital expenditures that –

- Are incurred during the _two-year period preceding_ the transfer by the partner to the partnership; and
- Are incurred by the partner with respect to –
  - Partnership organization and syndication costs described in Section 709; or
  - Property contributed to the partnership by the partner, but only to the extent that the reimbursed capital expenditures

---

do not exceed 20 percent of the fair market value of the property (at the time of the contribution). The 20 percent of fair market value limitation does not apply if the fair market value of the contributed property does not exceed 120 percent of the partner’s adjusted tax basis in the contributed property (at the time of contribution).^{1271}

The basic disguised sale rules have been promulgated under Section 707(a)(2)(B). Supplementary disguised sale rules under Section 704(c)(1)(B) and Section 737 can apply on partnership distributions of contributed property to another partner or distributions of other property to the contributing partner.^{1272}

This disguised sale provisions have produced forests of complicated rules.

h. Reasonable Guaranteed Payments and Preferred Returns.

A reasonable guaranteed payment for capital made to a partner is not treated as part of a sale of property. Designating a payment as a guaranteed pay-
ment for capital can be useful in avoiding disguised sale treatment. Guaranteed payments for capital and preferred returns for capital are important principally with respect to distributions made within two years of the contribution of property. After that, the two-year presumption takes over. The preamble to Treasury Regulations explains:

If a transfer characterized by the parties as a guaranteed payment for capital is not respected as such, the transfer is subject to the general rules of the final regulations, including the presumptions for transfers made less than or more than two years apart. The final regulations do not provide explicitly that a distribution properly characterized as a guaranteed payment for services is not treated as part of a sale. Although distributions of this type are not specifically excepted from the regulations and are subject to any applicable presumption, guaranteed payments for services should not be considered part of a sale of property under the facts and circumstances test, because they are not related to a transfer of property by a partner. Similarly, a transfer of money that represents a bona fide loan or a transfer of money in repayment of a bona fide loan should not be considered part of a sale of property under the facts and circumstances test.\textsuperscript{1273}

Treasury Regulations have their own idea of when a guaranteed payment for capital is reasonable. A guaranteed payment for capital means “any payment to a partner by a partnership that is determined without regard to partnership income and is for the use of that partner’s capital.”\textsuperscript{1274} “A transfer of money to a partner that is characterized by the parties as a guaranteed payment for capital, is determined without regard to the income of the partnership and is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed to be a guaranteed payment for capital unless the facts and circumstances clearly establish that the transfer is not a guaranteed payment for capital and is part of a sale.”\textsuperscript{1275} A single payment or a series of payments are not made for the use of a partner’s capital if the payments are designed to liquidate all or part of the partner’s interest in property contributed to the partnership rather than to provide the partner with a return on an investment in the partnership.\textsuperscript{1276}

Treasury Regulations provide that a \textit{reasonable} preferred return is an exception to the two-year presumption:

\textsuperscript{1274} Treas. Reg. § 1.707-4(a)(1)(i).
\textsuperscript{1275} Treas. Reg. § 1.707-4(a)(1)(ii).
\textsuperscript{1276} Id.
[A] transfer of money to a partner that is characterized by the parties as a preferred return and that is reasonable (within the meaning of paragraph (a)(3) of this section) is presumed not to be part of a sale of property to the partnership unless the facts and circumstances (including the likelihood and expected timing of the subsequent allocation of income or gain to support the preferred return) clearly establish that the transfer is part of a sale. The term PREFERRED RETURN means a preferential distribution of partnership cash flow to a partner with respect to capital contributed to the partnership by the partner that will be matched, to the extent available, by an allocation of income or gain.\textsuperscript{1277}

The definition of reasonable preferred returns and guaranteed payments requires that –

- The transfer is made to the partner under a written provision of a partnership agreement\textsuperscript{1278}
- That mandates payment for the use of capital in a reasonable amount, and
- Only to the extent that the payment is made for the use of capital after the date when that provision is added to the partnership agreement.\textsuperscript{1279}

Treasury Regulations have their own notion of when a guaranteed payment or preferred return is made in a reasonable amount. This requires that –

- The sum of any preferred return and any guaranteed payment for capital that is payable for that year does not exceed –
- The product determined by multiplying –
  - \textit{Either}, at the partner’s option,
    - The partner’s unreturned capital at the beginning of the partnership’s taxable year, or
    - The partner’s weighted average capital balance for the partnership’s taxable year (with either amount appropriately adjusted, taking into account the relevant compounding periods, to reflect any unpaid

\textsuperscript{1277} Treas. Reg. § 1.707-4(a)(2).
\textsuperscript{1278} The presumption for reasonable guaranteed returns or reasonable preferred returns will not apply if the partnership has an oral partnership agreement.
\textsuperscript{1279} Treas. Reg. § 1.707-4(a)(2).
preferred return or guaranteed payment for capital that is payable to the partner) by

- The safe harbor interest rate for that year.

The safe harbor interest rate for a partnership’s taxable year equals –

- 150 percent of –
- The highest applicable Federal rate (at the appropriate compounding period or periods) in effect at any time from the time that the right to the preferred return or guaranteed payment for capital is first established under a binding, written agreement among the partners through the end of the taxable year.

A partner’s unreturned capital equals the excess of –

- The aggregate amount of money and the fair market value of other consideration (net of liabilities) contributed by the partner to the partnership over
- The aggregate amount of money and the fair market value of other consideration (net of liabilities) distributed by the partnership to the partner other than
  - Transfers of money that are presumed to be guaranteed payments for capital,
  - Transfers of money that are reasonable preferred returns, and
  - Operating cash flow distributions.\textsuperscript{1280}

A special rule provides that guaranteed payments for capital, preferred returns, and operating cash flow distributions do not lose the benefit of the favorable presumption by reason of being retained for distribution in a later year.\textsuperscript{1281}

Several aspects of this rule merit care and introspection. One is that 150% of the applicable federal rate is limiting. This is a lower preferred return rate than many partnerships pay. Depending on the prevailing applicable federal rate, the permitted rate could be conservative indeed. The permitted rate is much more generous during periods during which the applicable federal rate is much higher.\textsuperscript{1282} There appears to be an ability to ratchet up the preferred return over time

\textsuperscript{1280} Treas. Reg. § 1.707-4(b)(2)(i).

\textsuperscript{1281} Treas. Reg. § 1.704-2(c).

\textsuperscript{1282} It would seem to have made more sense if the permitted rate floated at a specified number of percentage points above the applicable federal rate (rather than a percentage of the applicable federal rate.)
with increases in the applicable federal rates. The permitted rate is based on highest applicable Federal rate \textit{in effect at any time} from the time that the right to the preferred return or guaranteed payment for capital is first established under a binding, written agreement. The permitted preferred return rate will float up with increases in the applicable federal rate. The permitted rate does not decline with declines in the applicable federal rate.\textsuperscript{1283} A theoretical flaw in the limit for reasonable preferred returns is that it is not risk adjusted. No higher preferred return rates are permitted for extremely risky partnerships than are permitted for partnership when there is little risk.

The base used for calculating the highest permitted preferred return is the partner’s unreturned capital. The safe harbor (for reasons that are not apparent) permits the base to be determined at the beginning of each year rather than require that the base be adjusted during the partnership’s taxable year as capital is increased or decreased.

\textbf{i. Operating Cash Flow Distributions.}

Another safe harbor permits operating cash flow distributions without creating a disguised sale payment. This is a much more limited safe harbor than many believe. Consider the operating cash flow distribution safe harbor in drafting allocations during the first two years following a material distribution of property by the partnership. The operating cash flow distribution safe harbor is particularly important for drafting distribution provisions for the first two years following a contribution of property to the partnership.

The preamble to Treasury Regulations explains the safe harbor:

\textbf{C. Operating Cash Flow Distributions.}

\textit{The final regulations retain the rule that provides that transfers of money to a partner during a taxable year that do not exceed the partner’s interest in net operating cash flow are presumed not to be part of a sale unless the facts and circumstances clearly establish that the transfers are part of a sale. For this purpose, a partner’s interest in net operating cash flow distribution is determined based on the lesser of the partner’s percentage interest in overall partnership profits for the year or the partner’s percentage interest in overall partnership profits for the life of the partnership. The final regulations also retain the safe harbor allowing a

\textsuperscript{1283} The permitted interest rate apparently is based on a computational year of 365/366 days. Be cautious if you seek to go to the permitted limit, but used a computational year of 360-days. This will require some care in adjusting the permitted rate for a 360-day year.
partner, in any taxable year of the partnership, to use the partner’s smallest percentage interest in any material item of partnership income or gain that may be realized in the three-year period beginning with such taxable year.\textsuperscript{1284}

An operating cash flow distribution is presumed not to be part of a sale of property to the partnership unless the facts and circumstances clearly establish that the transfer is part of a sale.\textsuperscript{1285} The operating cash flow distribution safe harbor blesses one or more transfers of money by the partnership to a partner during a taxable year of the partnership. The operating cash flow distribution safe harbor limits safe harbored distributions to the extent that they do not exceed the product of –

- The net cash flow of the partnership from operations for the partnership’s taxable year \textit{multiplied by}
- The lesser of –
  - The partner’s percentage interest in overall partnership profits for that year or
  - The partner’s percentage interest in overall partnership profits for the life of the partnership.

The net cash flow of the partnership from operations for a taxable year for purposes of the operating cash flow distribution safe harbor equals –

- The taxable income or loss of the partnership arising in the ordinary course of the partnership’s business and investment activities, \textit{Increased by} –
  - Tax exempt interest,
  - Depreciation,
  - Amortization,
  - Cost recovery allowances and
  - Other noncash charges deducted in determining the taxable income
- \textit{And decreased by} –
  - Principal payments made on any partnership indebtedness;
  - Property replacement or contingency reserves actually established by the partnership;

\textsuperscript{1285} Treas. Reg. § 1.707-4(b)(1).}
Some Comments on How to Compromise Drafting Partnership and LLC Agreements and Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements

- Capital expenditures when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow; and
- Any other cash expenditures (including preferred returns) not deducted in determining the taxable income or loss. 1286

The preamble to Treasury Regulations clarifies this rule:

In further response to comments, the final regulations clarify the presumption regarding operating cash flow distributions. In determining the net cash flow of a partnership, the final regulations provide that the starting taxable income or loss figure is increased by tax exempt interest and is decreased by capital expenditures only when made other than from reserves or from borrowings the proceeds of which are not included in operating cash flow. If a transfer of operating cash flow exceeds the amount allowed under the operating cash flow presumption, the transfer will qualify for the presumption up to the amount allowed under the presumption. The excess or portion of the transfer that does not qualify as an operating cash flow distribution is tested under the facts and circumstances test, subject to any presumptions that may apply. 1287

The operating cash flow distribution safe harbor does not permit distribution of the proceeds of partnership borrowing within the safe harbor. The operating cash flow distribution safe harbor does not permit the distribution of deposits, unrecognized payments under the completed contracts method, and payments that are derived from recovery of partnership capital in a transaction. The distribution of the proceeds of the sale of property contributed by the partner can fall outside of the operating cash flow distribution safe harbor in appropriate circumstances.

A partnership agreement might limit distributions to a contributing partner (which distributions otherwise would be made within two years of contribution of property by the partner) to distributions that qualify under the operating cash flow distribution safe harbor.

The partner’s percentage interest in overall partnership profits for that year is unresolved. Does this percentage include the partner’s participation in guaranteed payments? How do special allocations figure into the computation of this

1286 Treas. Reg. § 1.707-4(b)(2)(i). Where there is a tiered partnership agreement, the upper-tier partnership must take into account its share of the net cash flow from operations of the lower-tier partnership, so that the amount of the upper-tier partnership’s operating cash flow distributions is neither overstated nor understated. Treas. Reg. § 1.707-4(b)(2)(iii).
percentage? What is the effect of a minimum gain chargeback allocation? A special rule provides that, for any taxable year, the partner may use the partner’s smallest percentage interest under the terms of the partnership agreement in any material item of partnership income or gain that may be realized by the partnership in the three-year period beginning with the taxable year in determining a partner’s operating cash flow distributions for the partnership’s taxable year. This provision is intended merely to provide taxpayers with a safe harbor and is not intended to preclude a taxpayer from using a different percentage.\footnote{1288}

j. **Disguised Sale of Partnership Interests.**

The IRS was concerned that contributions and distributions of cash or property could be used to create transactions that, in substance, were sales of partnership interests. The IRS has published Proposed Treasury Regulations considering disguised sales of partnership interests.\footnote{1289} The rules for disguised sales of partnership interests are roughly parallel to the rules for disguised sales of property. The rules for disguised sales of partnership interests are heavily dependent on two-year presumptions that pivot on the date of admission of a partner. Consider these disguised sale of partnership interest rules in drafting your partnership agreement. Consider possible future events in the life of your partnership that might create disguised sales of partnership interests.

A transfer of consideration by a purchasing partner to a partnership and a transfer of consideration by the partnership to a selling partner constitute a sale (in whole or in part) of the selling partner’s interest in the partnership to the purchasing partner only if, based on all the facts and circumstances –

- The transfer of consideration by the partnership to the selling partner (including the assumption of a liability) would not have been made but for the transfer of consideration to the partnership by the purchasing partner; and
- The subsequent transfer is not dependent on the entrepreneurial risks of partnership operations in cases in which the transfers are not made simultaneously.\footnote{1290}

The determination is made based on a facts and circumstances test. The Proposed Treasury Regulations set forth a number of facts and circumstances. The Proposed Treasury Regulations state that the weight given to these facts and circumstances will depend on the particular case. The facts and circumstances are

\footnote{1288}{Prop. Treas. Reg. § 1.707-7.}
\footnote{1289}{Prop. Treas. Reg. § 1.707-7.}
\footnote{1290}{Prop. Treas. Reg. § 1.707-7.}
SOME COMMENTS ON HOW TO COMPROMISE DRAFTING
PARTNERSHIP AND LLC AGREEMENTS AND
SOME BASIC ISSUES IN
DRAFTING REAL ESTATE
PARTNERSHIP AND LLC AGREEMENTS

usually inspected on the earliest of the transfers. The facts and circumstances listed in the Proposed Treasury Regulations are:

- That the timing and amount of all or any portion of a subsequent transfer are determinable with reasonable certainty (at the time of an earlier transfer);
- That the person receiving the subsequent transfer has a legally enforceable right to the transfer or that the right to receive the transfer is secured in any manner, taking into account the period for which it is secured;
- That the same property (other than money, including marketable securities that are treated as money under Section 731(c)(1)) that is transferred to the partnership by the purchasing partner is transferred to the selling partner;
- That partnership distributions, allocations or control of operations are designed to undertake an exchange of the benefits and burdens of ownership of transferred property (other than money, including marketable securities that are treated as money under Section 731(c)(1)), including a partnership interest;
- That the partnership holds transferred property (other than money, including marketable securities that are treated as money under Section 731(c)(1)) for a limited period of time, or during the period of time the partnership holds transferred property (other than money, including marketable securities that are treated as money under Section 731(c)(1)), the risk of gain or loss associated with the property is not significant;
- That the transfer of consideration by the partnership to the selling partner is disproportionately large in relationship to the selling partner’s general and continuing interest in partnership profits;
- That the selling partner has no obligation to return or repay the consideration to the partnership, or has an obligation to return or repay the consideration due at such a distant time in the future that the present value of that obligation is small in relation to the amount of consideration transferred by the partnership to the selling partner;
- That the transfer of consideration by the purchasing partner or the transfer of consideration to the selling partner is not made pro rata;
- That there were negotiations between the purchasing partner and the selling partner (or between the partnership and each of the purchasing and selling partners with each partner being aware of the
negotiations with the other partner) concerning any transfer of consideration; and

- That the selling partner and purchasing partner enter into one or more agreements, including an amendment to the partnership agreement (other than for admitting the purchasing partner) relating to the transfers.\textsuperscript{1291}

Two-year presumptions are ( ) important under disguised sale of partnership interest rules:

- Within a two-year period a purchasing partner may transfer consideration to a partnership and the partnership may transfer consideration to a selling partner (without regard to the order of the transfers). The transfers are presumed to be a sale (in whole or in part) of the selling partner’s interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers do not constitute a sale.\textsuperscript{1292}

- A transfer of consideration by a purchasing partner to a partnership and the transfer of consideration by the partnership to a selling partner (without regard to the order of the transfers) may occur more than two years apart. The transfers are presumed not to be a sale (in whole or in part) of the selling partner’s interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfers constitute a sale.\textsuperscript{1293}

These two-year presumptions are supplemented with a special liquidation presumption: if a partnership transfers money (including marketable securities that are treated as money under section 731(c)(1)) to a selling partner in liquidation of the selling partner’s interest in the partnership, the transfer is presumed not to be a sale (in whole or in part) of the selling partner’s interest in the partnership to the purchasing partner unless the facts and circumstances clearly establish that the transfer is part of a sale.\textsuperscript{1294}

An exception is made for professional service partnerships. Transfers of money (including marketable securities that are treated as money under section 731(c)(1)) to and by a partnership that would be described in section 448(d)(2) if the partnership were a corporation (a professional service part-

\textsuperscript{1291} Prop. Treas. Reg. § 1.707-7(b)(2).
\textsuperscript{1292} Prop. Treas. Reg. § 1.707-7(c).
\textsuperscript{1293} Prop. Treas. Reg. § 1.707-7(d).
\textsuperscript{1294} Prop. Treas. Reg. § 1.707-7(e).
nership, for example, a law firm or an accounting firm), are not a sale and need not be disclosed. 1295

The Proposed Treasury Regulations concerning disguised sales of partnership interests contain safe harbors concerning reasonable guaranteed payments, reasonable preferred returns, operating cash flow distributions, and reasonable reimbursements of preformation expenditures.

Other aspects of the disguised sale of partnership interest regulations are beyond the scope of this article.

153. Conclusion.

No excellence of a form agreement will substitute for thought, experience and careful lawyering. Be careful. Ask for help in drafting a partnership agreement if you are over your head. Draft like a professional, not like a mere scribe.

1295 Prop. Treas. Reg. § 1.707-7(g).