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A PARTNERSHIP TAX DISTRIBUTION MENU

JUST SAY NO TO

No tax advisor wants to have to tell his or her clients that they owe a tax without receiving a corresponding amount of cash to pay it. Such cashless income is often referred to as "phantom" or "dry" income. Unfortunately for taxpayers investing in tax partnerships, phantom income issues frequently arise, because partners must recognize their shares of partnership taxable income regardless of whether they receive any distributions. ● Taxpayers who control their partnerships (such as general partners or LLC managers) can sometimes limit the impact of phantom income by simply causing their partnerships to make sufficient cash distributions under their general distribution provisions. The partnership would, of course, need to have cash available to distribute. The situation is harder for noncontrolling partners, who typically have no power to force partnership distributions beyond what is required in the partnership agreement. For them, protection from phantom income is achieved primarily through negotiated partnership tax distribution provisions. ● Tax distribution provisions generally require partnerships to distribute sufficient cash to their partners to allow them to fully

PHANTOM INCOME

A CAREFULLY DRAFTED PARTNERSHIP TAX DISTRIBUTION PROVISION ADDRESSES POTENTIAL PHANTOM INCOME CONCERNS BY PROVIDING CASH TO COVER TAXES ON PASS-THROUGH INCOME.

satisfy their federal, state, and local tax obligations on pass-through income and gain. Such provisions can take many forms and may vary in size, from a sentence or two to several paragraphs. All tax distribution provisions, however, share a common goal: providing cash to cover taxes on pass-through income. As discussed in detail below, some tax distribution provisions achieve this goal much more effectively than others.

The focus of this article is to provide and analyze a variety of tax distribution provisions. The discussion explores the good, the bad, and the ugly of various tax distribution arrangements. Further, a list (or "menu") of tax distribution provision options is provided for tax advisors seeking the best way to protect their clients from the dreaded scourge of phantom income. This should give readers the tools necessary to draft top-notch tax distribution provisions.[1]

Arguments For and Against Tax Distributions Partners are responsible for their share of partnership taxable income. Tax distributions provide cash to pay the tax that may be due on such income. Partners may recognize taxable income on allocations in excess of their partnership distributions for various reasons. The partnership, for example, may use its taxable profits to fund nondeductible expenditures (such as capital expenditures or principal payments due under a loan), or, alternatively, the partnership might apply its taxable profits to increase cash reserves.[2] In these circumstances, the partners must look to other sources of cash to fund the taxes payable on undistributed partnership profits.

Tax distribution provisions become particularly important for non-preferred partners, a term used to cover minority partners with little control, or even managing partners whose profit sharing begins only after the "money" partners are repaid. In many of these partnerships, the partnership agreement returns contributed capital to preferred partners before residual profits are shared by all partners. As a result, the partnership uses cash flow from taxable profits to repay capital contributions to preferred partners, while the tax allocations related to such profits (and the accompanying tax obligations) are spread among all partners. In effect, this is very similar to what occurs when partnerships apply taxable profits to repay principal under a loan. In each case, the partnerships use cash flow that could pay taxes to repay contributed capital or borrowings.

Tax distributions, however, are not treated the same under all partnership agreements for a variety of reasons. In some cases, the partnerships already distribute all available cash flow quarterly or more frequently, and all partners share profits and cash in the same ratio. In those cases, if the tax distribution is limited to available cash flow, the tax distribution would not change the manner in which cash would otherwise be distributed. In other cases, a significant percentage of the partnership is owned by tax-exempt persons who do not need or want tax distributions and do not want the partnership to use its precious cash to make unnecessary distributions. Although the taxable partner could negotiate for non-pro rata tax distributions only to the taxable partners, the non-receiving partners may view such non-pro rata distributions as imprudent or simply unfair. Further, a tax distribution provision may affect the business plan of the partnership if the partnership is required to use reserves, borrow, or reapportion cash distributions to pay partner taxes or to avoid events giving rise to phantom income. Alternatively, a partner who is entitled to a disproportionately large share of profits (i.e., a "carried interest") only after the money partners achieve a minimum rate of return may wish to forgo tax distributions if such money could otherwise be used to pay the preferred equity, and ultimately increase the return under the carried interest.[3] Partners in certain types of businesses, such as real estate or a start-up business, also may have significant depreciation or start-up losses from this or other unrelated investments that sub-

stantially reduce the likelihood of aggregate net phantom income.

If a partnership agreement does not have a tax distribution provision, taxable partners should generally review cash flow and tax projections to determine whether they will receive any phantom taxable income. In the case of a partner with a carried interest, taxable income often will not exceed any applicable "interest-like" preferred return payable to preferred partners until liquidation, in which case a tax distribution may not be necessary, assuming there are no other phantom income concerns. However, if the taxable income will exceed the preferred return, many non-preferred partners may find themselves facing phantom income from the partnership and should determine whether they have net deductions from other investments to offset the phantom income or if they

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EXHIBIT 1
Phantom GP Income

Phantom GP Income When GP Has Promote and Cash Returns Contributed Capital

Pre-Tax Cash Flow	LP	GP	Total
Capital Contributions	$99,000,000	$1,000,000	$100,000,000
Year 1 Distributable Cash			$12,000,000
Distributions of 10% preferred return	$9,900,000	$100,000	$10,000,000
Distributions – return of capital	$1,980,000	$20,000	$2,000,000
Total Distributions	$11,880,000	$120,000	$12,000,000

Taxable Income	LP	GP	Total
Year 1 taxable income			$12,000,000
First to preferred return	$9,900,000	$100,000	$10,000,000
Second with residual sharing (79:21)	$1,580,000	$420,000	$2,000,000
Total taxable income	$11,480,000	$520,000	$12,000,000
Tax liability (40%)	$4,592,000	$208,000	$4,800,000

Post-Tax Cash Flow	LP	GP	Total
Distribution surplus/shortfall	$7,288,000	($88,000)	$7,200,000

have sufficient liquidity outside the partnership to pay the taxes.

The following example illustrates how phantom income can occur when the cash waterfall first distributes taxable operating profits in excess of the preferred return to repay partner capital contributions (instead of distributing in accordance with residual sharing percentages). Under these circumstances, a non-preferred partner with a carried interest will receive taxable income based on its higher residual sharing percentage, but will receive distributions based on its lower share of contributed capital.

Example. LP and GP, respectively contribute $99 million and $1 million in cash to PRS, which PRS uses to buy Building. The distribution waterfall in the partnership agreement returns capital plus a 10% annual preferred return in the same 99:1 ratio in which capital was contributed, and then distributes profits 79:21 to LP and GP, recognizing GP's additional 20% "promote" share of profits.[4]

GP's phantom income is illustrated in Exhibit 1. In this example, GP finds itself with phantom income because, once the taxable income exceeds the 10% preferred return, GP receives only 1% of the distributions but is taxed on 21% of the related income (until all of the capital is returned).

Negotiating for Tax Distribution Provisions

A non-preferred partner who believes tax distributions are needed can sometimes encounter resistance from a preferred partner. An often effective response by a non-preferred partner is to argue that, if the entity was taxed as a Subchapter C corporation, the entity would be similarly required to pay income taxes at the entity level. Indeed, the use of a partnership model is simply shifting this entity-level tax obligation to the partner level. As a result, a non-preferred partner could persuasively argue that, like cash flow of a C corporation, partnership cash flow should cover taxes on partner-

1 For a more general tutorial on drafting partnership agreements, see Schneider and O'Connor, "Partnership and LLC Agreements: Learning to Read and Write Again," 125 Tax Notes 1,323 (12/21/2009).

2 If the controlling partner has significant discretion regarding the distribution of cash or holding of reserves, a minority partner can be at the mercy of a controlling partner unless the applicable partnership agreement includes a mandatory tax distribution provision. However, independent of the phantom income issue, most sophisticated partnership agreements set forth specific standards for when cash can be accumulated or must be distributed, with the degree of specificity being a negotiated point in the drafting process.

3 It may be more cost-effective for a carried interest partner to use other funds to pay taxes, with a cheaper cost-of-funds rate than the preferred return rate. Further, the carried interest partner may prefer to avoid these distributions if there is a possibility that it may have to pay the money back in the form of a "clawback" payment if there are insufficient earnings over the life of the partnership to pay the preferred return.

4 Note GP is given a full 21% of profits in this example for simplicity, although most transactions would provide GP with a total of only 20.8% of the profits, recognizing that GP's 20% promote should also dilute the return on GP's 1% of capital (20% of 1% reduces GP's capital return by 0.2%).

ship income. After all, to allow otherwise would cause the non-preferred partner to bear much of the tax burden on partnership income when the partnership, if incorporated, would fully shoulder that burden. In practice, this argument often convinces resistant preferred partners to accept at least some form of a tax distribution provision that benefits the non-preferred partner.

Despite this "corporate analogy" argument, a partner may continue to resist tax distributions, particularly if such partner is either tax-exempt or taxed at a much lower rate (such as an AMT taxpayer). A partner who does not need tax distributions, for example, may prefer to leave that cash in the partnership to generate additional profits,[5] and in any event will not typically want the partnership to incur debt and interest expense to make tax distributions. Ultimately, if the partners cannot agree on a tax distribution, they may decide that the partnership will make tax loans to partners with insufficient cash to pay their taxes. In these cases, the negotiation then turns to such issues as interest rates and repayment terms.

Baseline Tax Distribution Provision

A review of the following "baseline" provision is a helpful start to analyzing particular tax distribution provisions:

> ***Tax Distributions***. To the extent that the amount distributed to (or withheld on behalf of) any Member in respect of a fiscal year of the Company is less than such Member's Assumed Tax Liability, the Manager shall distribute cash equal to such shortfall to such Member, at such times as to permit the Member to timely satisfy estimated tax or other tax payment requirements. Each Member's "Assumed Tax Liability" shall equal the expected aggregate federal, state, and local tax liability of such Member attributable to items of income, gain, loss, and deduction allocated to such Member for income tax purposes (excluding allocations under Section 704(c) principles), assuming [the highest marginal income tax rates applicable to any Member] or [that such Member is an (individual/corporation) subject to tax at the highest marginal rate of income tax applicable to a resident in (Name of State and/or City)], taking into account the character of the relevant income or loss to such member and the deductibility, if any, of any state or local tax in computing any state or federal tax liability. Any amounts paid to Members under this section [ ] shall be treated as advances on distributions otherwise payable under this Agreement and are limited to available Net Cash Flow, with any shortfall prorated according to each Member's relative Assumed Tax Liability for such fiscal year.

In short, the above baseline tax distribution provision instructs the manager to distribute cash to the members to pay their assumed tax liabilities to the extent that the members have not already directly received sufficient distributions from the company (or indirectly received distributions through tax withholdings) to pay their taxes. The provision contemplates multiple distributions within a single year in order to fund estimated taxes. The provision also defines taxes broadly to include federal, state, and local income taxes.

The broad definition of taxes, however, excludes taxes on income allocations under Section 704(c). This approach is logical because Section 704(c) gain allocations, when triggered, generally will relate to unrealized gains that accrued outside of the partnership. As a result, the rationale for imposing an obligation to pay taxes on such gains on the partnership is not particularly compelling. This does not mean that a partner potentially subject to income allocations under Section 704(c) cannot negotiate to include such income allocations in a tax distribution provision. On the contrary, tax distribution provisions sometimes, either intentionally or inadvertently, treat Section 704(c) gain allocations no differently than other allocations of gain. Most tax professionals, however, would view extending the definition of taxes in a tax distribution provision to include Section 704(c) income allocations as outside customary practice.

By assuming that all members are either individuals or corporations subject to tax at the highest effective rate in a particular jurisdiction, the baseline provision allows the manager to calculate tax distribution amounts without having to undertake multiple calculations or review the tax returns of the members to ascertain their actual tax situations. Thus, if a partnership has individual partners in multiple state jurisdictions such as Florida (top state rate 0%), Virginia (top state rate 5.75%), and California (top state rate 10.3%), the agreement would specify California. This provision prudently trades precision for relative simplicity in determining tax distribution amounts. The provision also avoids potential disputes among partners by maintaining proportionate distributions and helping to keep partner information confidential.

The tax distribution provision above also includes language designed to avoid excessive tax distributions. For example, the provision takes into account the tax character of partnership income in determining tax distributions. The partnership, therefore, will not assume a higher ordinary-income tax rate for items that may qualify for reduced tax rates, such as long-term capital gains or certain dividends. Further, the provision follows the common practice of limiting potential tax distributions to available cash flow. In so doing, the tax distribution provision will not force the manager to borrow in order to make tax distributions and will allow the partnership to keep reserves.

Finally, and even more importantly, the provision treats tax distributions as advances on distributions otherwise payable to members. Tax distributions, as a result, are not intended to have an impact on the *amount* of partnership distributions ultimately received. Instead, such distributions are intended to affect only the *timing* of partnership distributions. This "advance" language is critical for preventing tax distributions from changing the economic arrangement of the partners (beyond the timing benefit).[6] Without such language, tax distributions become "permanent" distributions that can dramatically affect the economics of the partnership.[7]

Can We Make The Baseline Provision Better?

The rest of this article discusses alternative provisions to address additional "beyond the basics" issues. In most agreements, at least one of these issues will arise, although many practitioners only raise the most critical points in a single tax distribution provision for fear that addressing every possible issue would cause the partnership agreement to self-destruct from its own weight. These additional issues relate to:

1. Cash flow limitations.
2. Distribution timing and estimated taxes.
3. Determination of the applicable tax rate.
4. Coverage of non-income taxes.
5. Turning off tax distributions in liquidation.
6. Non-Section 704(b) income items.
7. Section 743(b) adjustments

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5 The need for cash reserves depends largely on the nature of the partnership's business (e.g., a technology partnership with significant research and development is likely to need more cash than a non-development real estate partnership).

6 Tax distributions inherently change the economics in that they effectively provide a time value of money benefit, since most do not require an interest charge for this cash advance. However, without the "advance" language a tax distribution can mean that the partnership is effectively paying the partner's taxes. For an example of this issue see Interactivecorp (f/k/a USA Interactive) and USANI Sub LLC v. Vivendi Universal, S.A., USI Entertainment Inc., and Vivendi Universal Entertainment LLLP, 2004 WL 1516149 (Del. Ch. 6/30/04).

7 Even this baseline provision can make tax distributions permanent to the extent that the partnership does not have a clawback provision to require the return of the prior tax distribution. This can occur when a service partner with no capital receives an allocation of taxable income, and a tax distribution, but there are offsetting economic losses in a later year that fully reverse the prior income. For example, an allocation to a service partner of $1 million of ordinary income in year one may entitle the partner to a $400,000 tax distribution. If the partnership later loses that same $1 million, absent a clawback obligation to return the tax distribution, the partnership may be able to only allocate the partner $600,000, the net capital account the partner has from the prior $1 million of income less the $400,000 tax distribution. For a discussion of clawback issues generally see Schneider, "How Do Investment Fund Clawback Provisions Affect Partnership Income Allocations?" 7 J. Passthrough Entities 27 (July-August 2004).

EXHIBIT 2
Cash Flow Limitation Provisions

Limitations on tax distributions: Cash flow and loan agreement limitations		
Sample language	**What it does**	**Observations**
To the extent of available cash as reasonably determined by the Manager in good faith	Caps tax distributions at an undefined “available cash” amount determined by manager in good faith.	For a simple agreement, this provision achieves a good balance of achieving the goal of limiting tax distributions to available cash flow but requires the manager to be reasonable in its determination of such cash flow.
The Manager shall cause the Company to distribute from Net Cash Flow or available reserves as reasonably determined by the Manager in good faith ….	Tax distributions limited to a pre-defined net cash flow, plus available reserves.	A solid baseline provision that takes advantage of the pre-defined net cash flow definition, which should be reviewed carefully by the non-preferred partner. Unlike many provisions, this one provides an advantage to the non-preferred partner by allowing “available reserves” to be used for tax distributions.
[P]rovided that cash is available for the distribution without the sale of capital assets or borrowing for the purpose of such distribution. . . .	Tax distributions limited to available cash without requiring an asset sale or refinancing.	A less common but okay middle-of-the-road simple method of defining available cash.
To the extent the Company has available cash for distribution by the Company under the Act and subject to any applicable agreement to which the Company or any of its Subsidiaries is a party governing the terms of indebtedness for borrowed money and subject to the retention and establishment of reserves, or payment to third parties, of such funds as the Board of Managers deems necessary with respect to the reasonable business needs and obligations of the Company. . . .	Limits tax distributions to available cash after reserves with broad discretion by the Board to define reserves; also limits distributions by other contractual obligations, such as lender limitations on equity distributions.	If the non-preferred partner doesn’t control the Board, the broad Board discretion to define reserves could be a problem. The non-preferred partner may wish to add more restrictive language or add a standard such as “reasonable best efforts” to ensure that the Board reasonably attempts to provide cash flow for tax distributions.
In no event shall the Company be required to borrow funds to make the distributions referred to in this paragraph nor shall any contribution by the Members be required to fund such distributions, but the Company shall maintain reasonable reserves to make such distributions to the extent permitted by any applicable lender. . . .	Company is required to maintain reasonable reserves for tax distributions; Company never required to borrow money and Members never required to contribute funds to make tax distributions.	This maintains a balance of interests between the preferred partners and the non-preferred partner with the requirement to maintain reasonable reserves for tax distributions versus no partnership obligation to borrow or call capital. These are good points to address, although for the sake of brevity they often are not addressed.
In the event that the Company has insufficient cash flow to pay the full amount of any tax distribution otherwise required under this Agreement, the Company [with the prior approval of the Board of Managers, may/shall] borrow on commercially reasonable terms such amounts as may be necessary to satisfy the resulting deficit.	Authorizing/requiring Board to borrow to make tax distributions.	An uncommon provision that is favorable to non-preferred partners who want to ensure no phantom income.
If on a Tax Distribution Date there are not sufficient funds on hand to distribute to each Member the full amount of such Member’s Assumed Tax Liability, priority shall be given to the distributions of Assumed Tax Liability distributable to [Members that are individuals].	Prioritizes distributions otherwise limited by cash flow to some partners over others.	This provision may be especially important for a non-preferred partner who is concerned about the cash flow limitation more so than another partner who has more wherewithal to pay the tax with outside funds.
To the extent not prohibited by the Credit Agreement (as amended, restated or otherwise modified from time to time, the “Credit Agreement”) or any subsequent agreement resulting from a refinancing of the Credit Agreement, the Company shall distribute cash in accordance with this Section in an aggregate amount equal to the Tax Distribution Amount for any Fiscal Year (the “Tax Distributions”).	Recognizes that credit agreements often limit cash available to partners for distribution, but generally allow for reasonable tax distributions.	This provision is a reminder that adding a mandatory tax distribution can be particularly important if there are lender restrictions on cash distributions.* Such tax distributions can be an important cash flow management tool and may encourage partners to agree upon a tax distribution that estimates taxes on the higher end of the spectrum to allow more partner cash flow.

* It is also very important to focus on the provisions of any credit agreement that limits distributions, including tax distributions, to partners to ensure that enough funds will be available for distribution to cover the partners’ cash needs for taxes.

8. Cumulative net income concepts.
9. Other special provisions.

The discussion concludes with some "baseline-plus" samples, provided in the final exhibit, incorporating concepts that may have appeal for drafters willing to go beyond the basics.

Issue 1: Cash Flow Limitations

What if, even with a tax distribution, non-preferred members express concern that the cash flow limitation effectively provides the manager with too much flexibility to overfund reserves and thereby limit cash flow? These members may also correctly point out that, if the partnership were a corporation, the entity would have to do whatever may be necessary to obtain the funds to pay taxes. Thus, the definition of cash flow often becomes a critical definition for a cash-poor partner dependent on a tax distribution provision, because most such provisions are limited to partnership cash flow, which the agreement can define in many different ways.

If the partnership includes a cash flow limitation that is broadly defined, the cash-poor partner should carefully review the projected taxable income and cash flow of the venture to ensure that the cash flow limitations on the applicable tax distribution section will not interfere with the partnership's ability to make adequate tax distributions. The cash-poor partner ultimately may insist on special approval or participation rights in determining cash reserves and other items that may limit the cash flow available for tax distributions. Of course such partners often have only minimal bargaining power and may not ultimately receive this right. Several sample cash flow and loan agreement limitation provisions are analyzed in Exhibit 2.

Issue 2: Distribution Timing and Estimated Taxes

The baseline tax distribution provision above requires the manager to distribute cash at such times as to permit members to make estimated tax payments. Many tax distribution provisions will more specifically provide that the partnership must make tax distributions quarterly on specified estimated payment dates, or by reference to the estimated tax due dates under the federal tax rules. Mandatory estimated tax distributions increase complexity, but adding them is good practice, because otherwise partners may need to seek partner-level short-term loans to fund quarterly estimated taxes and avoid penalties. Quarterly

EXHIBIT 3
Estimated Tax Provisions

Tax distribution timing: Quarterly estimated tax payment deadlines		
Sample language	**What it does**	**Observations**
Tax Distributions shall be made on or before each date prescribed by the Code for an [individual/corporation] to pay a quarterly installment of estimated federal income tax for a fiscal year.	Mandates quarterly distributions by reference to federal tax due date for individual or corporation.	Solid simple provision that addresses the need for quarterly distributions while maintaining some flexibility for the partnership in calculating the specific amount. However, by making the outside date the same date as date the tax is due, the partner may not have time to cash the check before writing its own check to the IRS.
Tax Distributions shall be made not less than [five] days prior to the date on which such Member would be obligated to make estimated tax payments or file a timely income tax return (without extension) with respect to such Member's share of the LLC's taxable income or loss in respect to such year or the year just ended.	Mandates quarterly distributions five days before generically defined estimated payment due dates.	Simple, maintains flexibility determining quarterly amounts, and allows partner five days to cash the partnership check before payment is due to the IRS. Generic enough that it works for both corporate and individual estimated tax due dates.
Tax Distributions will be made in installments four times a year (applying year-to-date estimates or projections of net taxable income as reasonably determined by the Board of Directors).	Mandates quarterly distributions but without specific reference to federal due dates for estimated taxes. Includes guidance on how to estimate amount of quarterly payment by using year-to-date estimates.	Simple, although missing reference to actual tax due dates. Adds in the helpful concept of reasonable projections, which is missing from most tax distributions. The reference to reasonable estimates of income provides the partner with a standard to help ensure sufficient distributions while maintaining some flexibility by the partnership to make "reasonable" estimates.
The Company shall make the distributions required by this Section either as soon as practicable after the close of its taxable year with respect to which the distribution is being made, or, as [reasonably] determined by the Manager in its [reasonable/sole] discretion, quarterly, based upon the due dates for estimated federal income tax for [a corporation/an individual].	Annual distributions are mandated and due "as soon as practicable" after year end. Manager has discretion to make quarterly distributions, with timing based on federal due dates.	This provides more flexibility to the partnership on timing than most provisions, allowing quarterly distribution only at the discretion of the Manager. This leaves material risk to the non-controlling partners as to whether they will have cash for estimated taxes.
The Board of Managers shall distribute, on a quarterly basis on or before April 1, June 1, September 1, and December [31] of each year, amounts of Distributable Cash that are sufficient to result in all of the Members receiving an amount that is equal to the Tax Distribution Amount, if any, including quarterly estimated payments of each such Member resulting from the allocations of income, gain and credit hereunder (the "Tax Distributions").	Mandates quarterly tax distributions by specified dates with flexibility on determining distributions per quarter as long as total amounts equal annual tax distribution amount.	The partnership may prefer the clear specified dates without having to look up the federal due dates, and it provides the individual partners two full weeks to cash their checks before their taxes are due. The downside of specified dates is that the tax rules could change and further, because corporate partners have a fourth-quarter due date of December 15, any corporate partners would necessitate changing the December 31 date to something like December 1.
(a) On or before each date prescribed by the Code for [an individual/corporation] to pay a quarterly installment of estimated federal income tax for a fiscal year, the Manager [may/shall] cause the Company to make a distribution to the Members [out of Distributable Cash] in an amount equal to the Estimated Tax for the portion of the fiscal year ending on the last day of the month immediately preceding the estimated payment date (reduced by prior distributions in respect of Estimated Tax for such fiscal year). (b) Within [90 days] after the end of each fiscal year, the Manager shall cause the Company to make a distribution to the Members in an amount equal to the Actual Tax for the fiscal year, reduced (but not below zero) by the aggregate prior distributions under Section ___ with respect to such fiscal year.	This provision makes quarterly distributions mandatory or optional (depending on the option chosen) and refers to the due date by reference to the federal tax due dates. The provision separates out "estimated" tax payments from "actual" tax payments to allow estimated taxes to be based on the cumulative income and quarterly distributions to date, such that the third quarter distribution looks to cumulative income and the cumulative tax distributions through the third quarter, rather than setting the quarterly distributions at 25% of the estimate of annual taxable income. There is no clawback if the overall actual tax would have been less than the estimated tax.	This includes many of the concepts in the earlier samples but layers on top a more detailed method of computing the exact amount of quarterly distributions, taking into account how income may not be even throughout the year. If there are profits in earlier quarters and losses in later quarters, nothing requires the partner to return the extra tax refund it will receive after it files its annual tax return. Few agreements are this specific, but it arguably provides more certainty to the partners that the quarterly distributions will match up with cumulative quarterly estimated tax payment obligations.

distribution provisions sometimes compromise on detail in order to allow flexibility, but at the cost of less certainty to the partner who is concerned about payment of taxes.

Complexities can arise with estimated tax provisions. For example, most tax distributions simply disregard the difference in estimated tax due dates between calendar-year corporations and individuals. For individuals and corporations, the first three quarterly deadlines are the same, April 15, June 15, and September 15, but the fourth-quarter deadline differs (December 15 for corporations and January 15 for individuals).[8]

Estimated tax provisions rarely address the mechanical complications that arise when a partnership swings between producing income and incurring loss within a single tax year. As a general rule, the estimated tax due is 25% of the required annual estimated tax amount under the Code,[9] and most tax distribution provisions follow a similar concept and compute the tax distribution based on annual estimated taxable income. However, very few provisions directly address the anomaly that occurs if there is net income for some quarters and a net loss for other quarters, or even disparate percentages of income between the quarters.

For example, the partnership may have estimated income for the first half of the year and made estimated tax distributions, but then swing to a loss in the second half. Should the partners owe some or all of those excess tax distributions back to the partnership, when the net losses in the second half would result in a lower tax distribution computation for the year as a whole? Most tax distribution provisions simply do not address this possibility. Exhibit 3 reviews sample language used in various estimated tax provisions.

Issue 3: Determination of Applicable Tax Rate

One of the most difficult aspects of drafting a tax distribution provision relates to the tax rate to be used in calculating actual tax distributions. The baseline tax distribution provision above calculates tax distributions for all partners by alternatively applying the highest marginal rate for a specified tax jurisdiction or applying the highest rate applicable to any of the partners, taking into account the character of the underlying income. This approach of picking a single rate for all partner tax distributions is often done out of fairness, to treat all partners equally regardless of the jurisdictions in which they live, while ensuring sufficient distributions for partners in high-tax jurisdictions to pay their taxes. This mechanism also has the advantage of simplicity and practicality.

Although stating a fixed defined rate in the document is the simplest approach, it is far less favored because it raises practical issues, as tax rates inevitably change over time. Therefore, the most common approach applies the "highest rate" analysis, either by defining a specific jurisdiction where the highest rate partner lives (or could live) at the time the tax distribution provision is written or by generic reference to the jurisdiction with the highest rate where any partner lives (or could live) during the particular year the tax distribution is applicable. Although the latter approach is arguably more accurate because it looks at the rates year by year, it is

8 See Section 6654(c)(2) for the deadlines for individuals and Section 6655(c)(2) for the deadlines for corporations. The problem becomes more complex and requires focused drafting where major partners report their taxable income on a non-calendar year.

9 See Sections 6654(d)(1) and 6655(d)(1).

EXHIBIT 4

Tax Rate Provisions

The Applicable Tax Rate		
Sample language	**What it does**	**Observations**
Tax Rate means 40% for ordinary income and 20% for items taxed as capital gains.	Selects two fixed, non-changeable tax rates that take into account tax rate differences between ordinary income and capital gains.	Simple, but not recommended. The tax rates at both the federal and state levels simply change too frequently.
Tax Rate means the highest combined federal, state, and local income tax rates for the type of income (e.g., ordinary income or capital gain), taking into account the federal deduction for state taxes if applicable, and taking into account the localities in which the Members reside.	Selects a flexible combined tax rate based on the highest possible partner rate at the federal, state, and local levels, after taking into account character differences in income items and, if applicable, the federal deductibility of state taxes.*	This is flexible for changes in tax rates and encompasses federal, state, and local taxes. However, it requires an evaluation of where individual partners live and their local tax rates and potentially involves different rates of tax distributions for different partners, which arguably unfairly benefits partners in high-tax jurisdictions. This provision is also unclear as to what type of taxpayer to assume for determining the applicable rate (e.g., individual or corporate).
The highest combined marginal federal, state and local tax rates then applicable to an individual or corporation in any jurisdiction in which a Member is resident or the Company does business (whichever is higher) on income or gain of the category represented by such allocation (assuming the Member has no income or loss from sources other than the Company, and treating state and local taxes as fully deductible).	Selects a flexible combined tax rate for both individual and corporate partners based on the higher rate of their residency or where the entity conducts business.	This provision is very broad and thorough, but succinct. The provision uniquely addresses how, for a flow-through entity, the net state tax obligations are generally based on the higher of the taxes where the partnership does business or where its partners reside. The provision also addresses how the partnership may have both individual and corporate partners by looking to the higher of the individual or the corporate rate.
"Tax Distribution Rate" is determined by assuming (without regard to such Unit Holder's actual tax liability) that such income or gain, as applicable, is taxable to the Unit Holder at a combined effective federal and state income tax rate reflecting the deductibility of state income taxes for federal income tax purposes and by using for each Unit Holder the highest marginal federal income tax rate then in effect, and a state income tax rate equal to the highest marginal rate then in effect for the state in which any Unit Holder resides (with the state of residence of a Unit Holder that is a "flow through" entity for tax purposes determined to be the state or states of residence of any direct or indirect owner of the entity who is responsible for paying taxes on such income), taking into account the character of such income or gain.	Selects a flexible combined tax rate based on the highest rate applicable to any partner after taking into account the character of income, the deductibility of state taxes and, perhaps most importantly, the possibility that partners may be flow-through entities. Note this does not cover local taxes.	This provision is similar to others (except for not covering local taxes); however, this provision uniquely addresses the determination of the tax rate for a partner that is a flow-through entity.
The Tax Rate shall be determined by assuming a tax rate equal to the maximum combined federal, state and local income tax rates that would be applicable if the Manager were an individual resident of New York City, applying the highest marginal rate applicable to ordinary income or capital gains, depending on the character of the underlying taxable income and after giving effect to any federal deduction for state and local taxes, but without consideration of the effect of any other deductions, offsets or credits available [to the Manager (or its direct or indirect owners)] from other sources, and shall be appropriately adjusted to take into account (1) the different tax rates that may be in effect for different types of income or different taxable years, as well as (2) with respect to distributions for a particular Member, any items of tax deduction or loss if the Manager reasonably believes that the Member may not be permitted to apply such items of deduction or loss to reduce its (or their) taxable income by reason of Section 212 of the Code or otherwise.	Selects a flexible combined tax rate based on the highest possible rate applicable to an individual residing in New York City (which has historically been a high-tax jurisdiction) after taking into account income character, the deductibility of state and local taxes and, somewhat uniquely, the possibility that certain expenses or losses ultimately will not be deductible for certain partners.	This provision simplifies the determination of the state and local tax rate by picking a specific high-tax city as the baseline, at the risk of a partner moving into a locality with taxes higher than those of the defined city. The provision also clearly states that the federal deduction for income taxes should include local income taxes as well as state income taxes. The provision uniquely addresses how certain expenses, such as management fees, are Section 212 expenses that may not be deductible to a partner because of either general income tax limitations on itemized deductions or limitations under the alternative minimum tax.

* In the case of high-income individuals, it is often advantageous (to them) to provide that the deductibility of state taxes for federal tax purposes is not taken into account, because these taxpayers are subject to the AMT and state taxes are not deductible for that purpose.

EXHIBIT 5
Non-Income Tax Provisions

Coverage of Non-Income Taxes		
Sample language	**What it does**	**Observations**
Each Member's "Assumed Tax Liability" shall equal the expected aggregate federal, state, and local tax liability of such Member attributable to items of income, gain, loss, and deduction allocated to such Member for income tax purposes (including [self-employment], [Medicare] and [Section 1411 taxes] but excluding allocations under section 704(c) principles).	Includes self-employment and Section 1411 Medicare taxes among the types of taxes taken into account in calculating member-assumed tax liabilities.	Because many partners currently are subject to self-employment taxes and, beginning in January 2013, partners currently not subject to self-employment taxes may face new Medicare taxes under Section 1411; this provision adds those taxes to the taxes taken into account in determining member tax distributions.

much more complex in practice if partners change locations or the top tax rate changes among existing localities where partners reside.

In reality, the tax rate formula is a dramatic oversimplification. In a perfect world, the tax rate used would take into account all of the variables that affect the partners' tax liabilities from partnership income allocations. For example, if some partners are corporations and others are individuals, the corporate partners do not receive a capital gains preference. Further, some partners, such as high-net-worth individuals, receive very limited, if any, benefit from tax deductions under Section 212, often resulting from management fees paid by the partnership. These expenses may not be deductible to partners because of the limitations on itemized deductions for individuals or the treatment of such expenses as nondeductible "preference" items under the alternative minimum tax. Finally, if Congress passes the proposed Section 710 carried interest legislation, it will be difficult for tax distributions to fairly address income that will qualify as "capital gain" at the partnership level but will be taxable at the higher ordinary income rate for the service partner.

Sample provision language relating to the applicable tax rate is examined in Exhibit 4.

Issue 4: Coverage of Non-Income Taxes—Self-Employment and Medicare Taxes

Should the applicable tax rate in a tax distribution provision include self-employment taxes under Section 1402, and Medicare taxes under effective Section 1411? Many tax advisors would say "yes." After all, many partners face (or will face) employment/Medicare taxes under Section 1402 or 1411 in addition to income taxes on their shares of partnership income. Section 1402 reaches many individual partners who are active in the businesses of their partnerships, while, beginning in 2013, newly effective Section 1411 will reach many individuals who are passive in the businesses of their partnerships. The tax rate for both of these taxes will be 3.8% (not taking into account higher self-employment tax rates on income amounts below the Social Security threshold).

Further, if proposed Section 710 carried interest legislation becomes law, many carried interest holders will become subject to self-employment tax.[10] Thus, if these taxes are not taken into account, many partners will need to look to other sources of cash to pay at least a portion of their taxes on partnership pass-through income. Accordingly, to allow partners to fully fund their entire overall tax burdens on partnership income, tax distribution provisions should address both self-employment taxes under Section 1402 and Medicare taxes under Section 1411 (as they relate to their distributive shares of partnership income, as opposed to such taxes applicable to Section 707(c) guaranteed payments). This conclusion is consistent with the C corporation analogy because including self-employment and Medicare taxes will force the entity, like a C corporation, to cover all taxes on entity income regardless of how those taxes are labeled or referred to. Distribution provision language relating to non-income taxes is examined in Exhibit 5.

Issue 5: Turning Off Tax Distributions in a Liquidation

Some partners reason, often correctly, that in the event of a capital event or liquidation, adequate cash will be available for distributions to partners to pay taxes regardless of whether the agreement contains a tax distribution provision.[11] Further, the liquidation may be viewed as the time needed to correct any skewing of cash distributions as a result of earlier tax distributions. These partners, therefore, may seek to exclude capital and liquidating events from tax distribution provisions. Liquidating events should generally not give rise to phantom income. After all, a liquidating event by definition results in the partnership distributing all, or at least nearly all, of its cash resources. Non-liquidating capital events, however, could produce proceeds used solely to pay down preferred capital or partnership debt. Thus, not every capital event results in cash flow available for tax distribu-

[10] For a discussion of carried interest legislation see Schneider and Towsner, "A Developer's Guide to Carried Interest Proposals," Washington Business J., 8/27/2010—9/2/2010. For a more general discussion of partnership compensatory interests, see Schneider and O'Connor, "Proposed Rules Substantially Change the Treatment of Compensatory Partnership Interest: Are You Ready?" 8 J. of Passthrough Entities 35 (September-October 2005).

[11] Partners may also find protection from provisions requiring the timely distribution of capital transaction proceeds.

EXHIBIT 6
Liquidation Provisions

Turning Off Tax Distributions as Part of a Liquidation		
Sample language	**What it does**	**Observations**
Notwithstanding the foregoing, [income for determining tax distributions] shall not include any gain recognized for U.S. federal income tax purposes on the sale of any asset not in the ordinary course of business after the Board of Directors has resolved to liquidate the Company.	Prohibits tax distributions on extraordinary income recognized from selling assets after a formal dissolution resolution.	Simple and clear exclusion of tax distributions on liquidation gains with clear line for when liquidation restriction begins.
Notwithstanding the foregoing, no Tax Distributions shall be made in connection with the liquidation of the LLC or with respect to any proceeds realized by the LLC upon any transaction (other than in the ordinary course of business of the LLC) at the time of or in connection with such liquidation.	Expands on the sample above to also exclude any tax distributions "in connection with" liquidation.	Simple and broad exclusion of tax distributions on both liquidation gains and any income "in connection" with a liquidation; however, liquidation start date is more flexible.

tions. Further, because a partnership may spread its actual dissolution over an extended period, turning off tax distributions could cause partners to have insufficient cash flow to pay estimated tax payments from asset sales undertaken as part of the dissolution process.

Sample provision language, prohibiting distributions during a liquidation, is included in Exhibit 6.

Issue 6: Non-Section 704(b) Income Items

Many tax distribution provisions reference taxable income only from allocations of Section 704(b) profits under the partnership's general income allocation provision.[12] This is logical because such income represents the true economic profits of the partnership. However, taxable income can arise in other ways. As noted previously, the baseline tax distribution provision excludes allocations of taxable income under Section 704(c) based on the notion that built-in tax gains should not be the partnership's responsibility.[13] The next question is whether the tax distribution should cover other events that trigger taxable income to partners. These other gain trigger events include:

- Sections 704(c)(1)(B) and 737 relating to the "mixing bowl" rules.
- Section 751(b) relating to "hot asset" exchanges.
- Section 731(a) gain relating to distributions in excess of basis.
- Section 707(a) relating to payments to partners in non-partner capacities such as "disguised sales."[14]

A related question is how to take into account basis adjustments that are special to a partner under Section 743(b). These items are addressed below.

Mixing Bowl and Disguised Sale Gain. Similar to the lack of sympathy for Section 704(c) built-in gain, tax distributions typically do not cover mixing bowl gains under Sections 704(c)(1)(B) and 737 or disguised sale gains under Section 707.[15] The notion is that such gain really relates to built-in gains that the partner had before coming into the partnership, and why should the partnership provide liquidity for such events? The counterpoint is that the tax distributions are only advances on a partner's share of partnership equity, so they are more like loans (albeit at a zero interest rate), and it is not desirable to have the IRS chasing cash-strapped partners for taxes, especially if they are supposed to be concentrating on operating the business of the partnership.

Section 731(a) Gain. Partners recognize taxable income under Section 731(a) when they receive actual or deemed distributions of cash in excess of their tax basis. This gain may represent, in part, built-in gain under Section 704(c), but it could also represent

12 Most tax distributions either cross-reference the paragraph in the agreement that allocates Section 704(b) income as the baseline for the tax distribution or they refer to "income allocated" which by definition would exclude non-entity-level income items that would not be "allocated" by the partnership. In the latter approach, it is important to specifically exclude Section 704(c) income if it is not intended to be covered by the tax distribution.

13 Note that some partnership agreements are designed to help partners with built-in gain assets by promising not to sell those assets for a period of years or agreeing to be liable for those taxes under a tax protection agreement. This is common for partnerships controlled by real estate investment trusts.

14 If a partnership agreement provides for Section 707(c) guaranteed payments for services or capital, special attention should be paid to whether these payments are, likely accidentally, covered by the tax distribution provision. Note that guaranteed payments are treated as an "allocation" of partnership income for certain tax purposes. See Reg. 1.707-1(c).

15 Under the mixing bowl rules in the Code and regulations, a partner who contributes property to a partnership and receives distributions of property (other than money) from the partnership may be required to recognize the built-in gain in the property to the extent of the excess of the distribution over the partner's basis in its partnership interest immediately before the distribution. A similar result occurs if the partnership distributes the contributed built-in-gain property to another partner.

16 The case for including Section 731(a) gain is more sympathetic for a partnership that does not have any Section 704(c) appreciated assets.

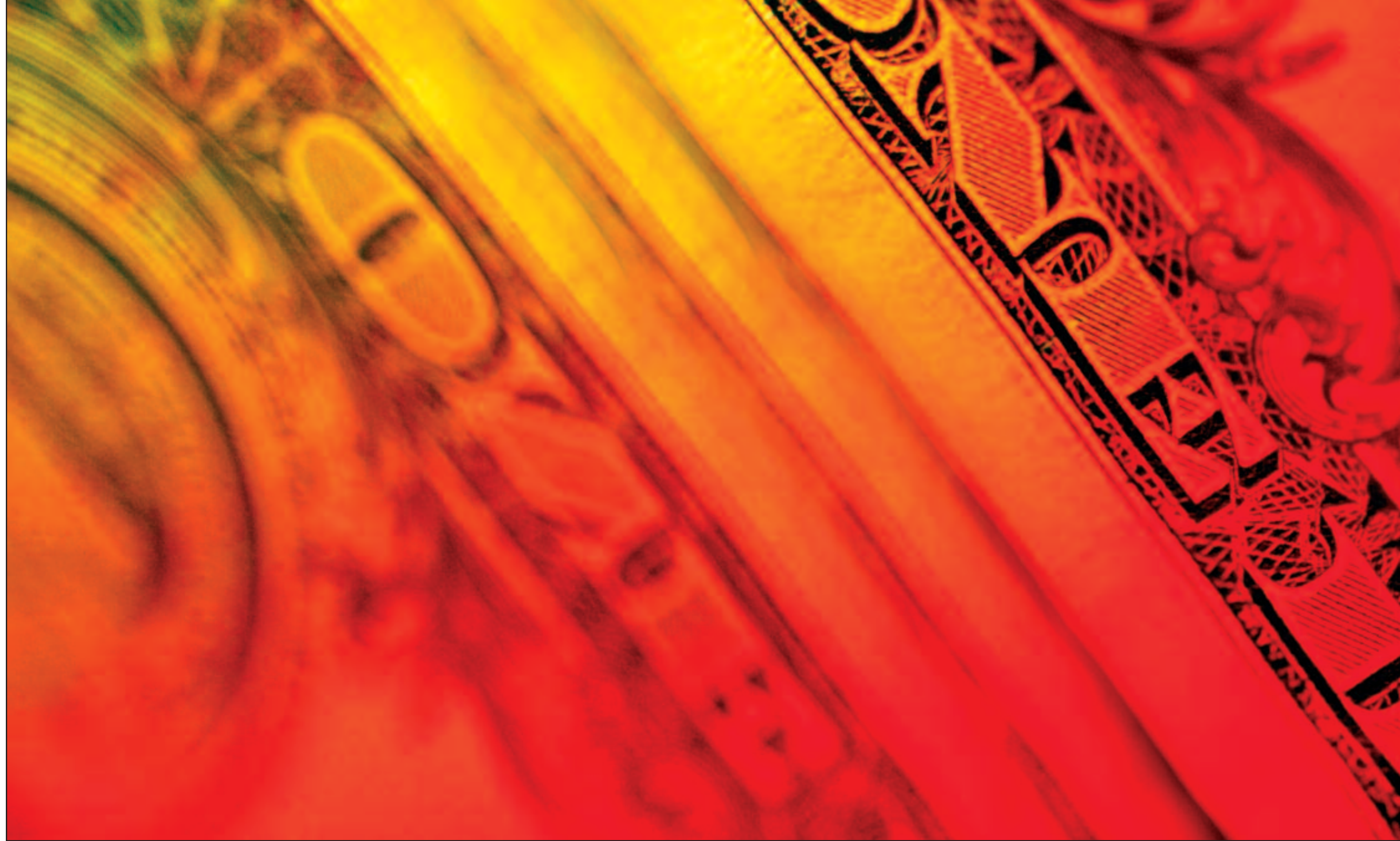
unrealized gain from the partner's share of appreciation accrued while the assets are held by the partnership. Of course, if the partnership actually distributes cash (or marketable securities) to the partner to trigger this gain, there is no reason to distribute additional cash to pay the tax. However, the argument is more compelling if the gain results from a deemed distribution of cash, such as when partnership debt shifts away from the partner under Section 752. In practice, because Section 731(a) gain arises at the partner level, very few tax distribution provisions cover such gain because the tax distribution usually applies to only "allocated" income or gain. To the extent Section 731(a) gain relates to Section 704(c) built-in gain, this approach is consistent with the general goal of tax distribution provisions.[16] Indeed, tax distribution provisions are intended to limit phantom income on undistributed partnership profits. They are not intended to effectively impose a tax burden on partnerships for partner-level taxable events.

Section 751(b) Hot Asset Gain. Assistance with partner taxes arising from disproportionate distributions involving "hot assets" (such as unrealized receivables) is arguably more logical than helping partners with other types of gain discussed above, yet such taxes are still not typically covered in tax distribution provisions. For example, if a partnership owns both ordinary income and capital assets and disproportionately distributes the capital or the ordinary assets to one partner, Section 751(b) deems a taxable exchange of assets between the partner and the partnership to have occurred. To the extent that a deemed Section 751(b) exchange generates a partner-level tax, the partner-level tax would not be covered in a typical tax distribution provision, even though the partner may not have liquidity to pay the tax. Much like the other categories of gain discussed above, partners should not expect to get much traction for including this type of gain in a tax distribution agreement, under the theory that it is too unlikely an event or that the partner could simply sell the distributed assets to pay the tax.

Issue 7: Section 743(b) Adjustments

What if partners have (or potentially could have) offsets against their shares of partnership income or gain? Partners, for example, could have Section 743(b) adjustments that effectively reduce their net taxable income from the partnership. Should a tax distribution provision take these items into account? Alternatively, partners could have negative Section 743(b) adjustments that effectively increase their taxable income from the partnership. How should these items impact tax distributions?

Although as a policy matter most would agree that it makes sense to take into account both positive and negative Section 743(b) adjustments, very few



tax distribution provisions address this point. Positive Section 743(b) adjustments may provide partners who are entitled to such adjustments with a windfall if they are not taken into account. Similarly, partners subject to negative Section 743(b) adjustments may need them to be taken into account to avoid having insufficient tax distributions. The practical reality, however, is that events that give rise to positive or negative Section 743(b) adjustments result from sales or distributions generally well after partnership formation. As a result, when the tax distribution is first drafted, partners simply will not know whether they might be subject to either positive or negative adjustments in the future. Thus the lack of a clear economic interest in the issue, along with the practical complications of accounting for Section 743(b) adjustments, and the theoretical nature of the issue typically result in Section 743(b) adjustments, unfortunately, not being covered.

Issue 8: Cumulative Income Concepts

A commonly negotiated issue is whether partnerships should calculate tax distributions based on income over the life of the partnership, or just income in a particular year. As a policy matter it makes sense that a partner which received $100 of deductible loss in year one and $100 of taxable income in year two should not be entitled to a net benefit from a tax distribution when there was no net taxable income over the two years. However, in most cases the partners have already spent the tax savings from the year one loss, so denying the tax distribution for the year two income may result in a very real cash flow problem. The problem becomes even more pronounced when the losses and income are many years apart. Further problems can arise if the losses were capital losses and the later income is ordinary income.

High-net-worth partners (and many corporate partners regardless of their size) are more likely to agree that tax distributions should take into account losses allocated to partners in previous years. After all, if the partnership has not produced phantom income on a net basis, these partners are likely to ask why the partnership should pay tax distributions. Further, if partners have obtained tax benefits from prior partnership losses, arguably they should set aside some of the cash associated with those benefits for use in the future when the partnership becomes profitable. Finally, using the C corporation analogy, if the partnership was a C corporation, losses from prior years would have created a net operating loss that the corporation could carry forward to offset the income generated in future years. Stated differently, a partnership arguably should not pay tax distributions if it would not have an entity-level tax obligation if it converted to corporation status.

Low-net-worth partners (and many individual partners regardless of their size) will generally wholeheartedly disagree. To those partners, any benefits associated with prior losses have disappeared long before the year the partnership become profitable. As a result, when the partnership begins to produce profits, these partners will find themselves in a serious cash crunch. Also, as a practical matter, very few partners will set aside some of the tax benefits from loss allocations in past years for future profitable years. Accordingly, these partners will argue for tax distributions that do not take into account losses from previous years. Exhibit 7 examines sample provision language relating to cumulative income concepts.

Issue 9: Other Areas of Concern

Additional areas that tax distribution provisions may need to address include:

EXHIBIT 7
Cumulative Income Concepts

Cumulative Income Concepts		
Sample language	**What it does**	**Observations**
[A]n amount equal to the product of the cumulative historic taxable income allocated to a Member pursuant to this Agreement (after reducing such taxable income by any taxable loss so allocated to such Member for all Fiscal Years, or portions thereof, ending on or before or which includes such current Fiscal Year) multiplied by the Tax Rate.	Applies tax distribution based on cumulative multi-year income allocated to the Member. In determining cumulative income, it does not make a reference to the effect of special partner Section 743(b) adjustments on such income, so such amounts are presumably excluded from the calculations. Provision should consider adding language that only nets income and losses over multiple years to the extent that they are of the same character (capital vs. ordinary).	The cumulative income concept means that a partner could have a current tax liability without a tax distribution if there were prior year losses, even if such prior year losses were unusable capital losses. Further, no provision is made for potential partner-specific Section 743(b) adjustments, creating even further potential economic distortion. An individual partner without meaningful outside cash flow may resist the cumulative income concept.
The determination of a Member's taxable income for the current year shall be reduced by any cumulative taxable loss previously allocated to each Member (including Losses allocated to a predecessor of a Member) in prior fiscal years which have not been offset by subsequent allocations of taxable income.	Cumulative income concept similar to the immediately prior sample except this uniquely requires a partner to succeed to the tax history of a predecessor partner.	Analysis similar to the immediately prior sample. Both samples also do not take into account built-in gain triggered under Section 704(c), 731(a), 737, or 741. Consider limiting the language regarding predecessor losses to be limited to 80% or more affiliated predecessor entities.

1. Clawbacks.
2. Adjustments and income reallocations.
3. Discretionary refusal of a tax distribution.

Clawbacks. Unique tax distribution issues arise with carried interests. Often a partnership will have profits in early years followed by losses in later years. In such cases the principals will have received more in tax distributions than they would have if the later losses had been known upfront. This situation is common for general partners of investment funds, which are often required to return the prior distributed profits through a clawback or a similar "deficit capital account" make-up provision. However, what if the partnership agreement does not provide for such a clawback provision? Alternatively, even if a clawback provision is included, should the clawback be "tax adjusted" to take into account that the loss allocable to the carried interest partner may not be currently deductible?

For example, assume that a partner receives a profits interest entitling the partner to 20% of partnership profits. In year one, the partnership generates $100 in profits, allocates $20 to the carried interest partner, and distributes $8 to the carried interest partner as a tax distribution under a relatively standard tax distribution provision. As a result, the carried interest partner's capital account increases from $0 to $12 ($0 opening capital account + $20 allocation - $8 distribution = $12). In year two, the partnership incurs a $100 loss, 20% of which ordinarily would be allocated to the carried interest partner. However, if the carried interest partner's losses are limited to its positive capital account, the carried interest partner receives only $12 of the partnership loss, and the other partners receive $8 of the carried interest partner's loss.

Although this problem of over-distributing on a net basis to the partner with a profits-only interest arises as a result of a tax distribution provision, the "fix" to this problem is not in the tax distribution paragraph. Instead, partners generally fix this problem by imposing a clawback on the service partner. Under a clawback provision, the service partner becomes subject to an obligation to return excess distributions. Note that some clawback provisions are written as "tax adjusted" to reduce the clawback obligation to the extent that the service partner could not receive the full tax benefit of the offsetting loss allocation. This can occur, for example, if the loss is a capital loss and the service partner does not have capital gains to absorb the loss.

Adjustments and Income Reallocations. What if the partnership becomes the subject of a tax audit and, as a result of the audit, partnership income from prior years is increased? In these circumstances, partners may find they have to pay taxes, interest, and penalties related to prior years. Shouldn't they have the right to a tax distribution to cover this unexpected liability? In order to be consistent, it may be that the answer should be "yes." Nevertheless, many tax distribution provisions do not address how to handle audit adjustments. Similar issues also arise in the event that a taxing authority either increases or reallocates prior-year partnership income.

Discretionary Refusal of a Tax Distribution. For a partnership that includes a carried interest, the partner entitled to a disproportionate profit

EXHIBIT 8
Other Special Provisions

Other Special Provisions		
Sample language	**What it does**	**Observations**
Audit Adjustments. If, following an audit or examination, there is a determination that a Member has been under-allocated items of income or gain [(or should have recognized income as a result of guaranteed payments or capital shifts)] or over-allocated items of loss or deduction such that the Member has an additional tax liability (determined under the assumptions used to determine a Member's Cumulative Tax Liability), the Company shall promptly distribute to such Member as a Tax Distribution an amount equal to such additional tax liability plus any interest and penalties thereon. If there is a determination that a Member has been over-allocated items of income or gain or under-allocated items of loss or deduction such that cumulative Tax Distributions previously paid are in excess of the Member's Cumulative Tax Liability, such Member shall promptly pay to the Company the amount of such excess, provided, however, that a Member shall not be required to pay an amount greater than any cash refund actually or constructively received or other cash benefit resulting from the relevant adjustment, and provided, further, that in lieu of paying an excess that a Member would otherwise be required to pay, a Member may instead elect to have the Company reduce future distributions to such Member by the amount of such excess.	Automatically provides additional tax distributions to partners who owe more tax because of an audit adjustment, with partners who are entitled to a refund from audit adjustments being required to either return the refund to the partnership or reduce their rights to future distributions by the refund.	This provision is an example of addressing detail that most people would agree is sound economic policy but simply too complicated for the average partnership agreement. The same concept could likely be included with the use of simpler, but less exacting language and have a higher likelihood of being used as a practical matter.
Income reallocations. In the event that there is a reallocation of income or loss among the Members or any other person (the "Reallocated Items"), to the extent that tax distributions were originally made to any person with respect to such Reallocated Items, such persons who received distributions pursuant to paragraph [tax distribution paragraph] with respect to such Reallocated Items shall return such distributions to the Company. The persons who received an allocation of the Reallocated Items described immediately above shall be entitled to tax distributions pursuant to this paragraph in an amount equal to the distributions that would have otherwise been distributed to such person or persons under paragraph [tax distribution paragraph], had such amounts been originally allocated to such person or persons.	If there is a reallocation of income among the partners, theoretically by audit or simply as a result of an amended return, tax distributions are adjusted to take into account the changed sharing of income, with partners being required to return any excess distributions.	This is similar in concept to the audit adjustment sample immediately above, except its relative brevity may make it more likely to be used even though it is less precise.
Non-U.S. taxes excluded. The Company shall have no obligation to make any distribution to any Member to enable such Member to pay any taxes assessed by any non-U.S. jurisdiction.	This provision explicitly excludes non-U.S. taxes from the calculation of any potential tax distribution amount.	Most tax distributions specify only federal, state and local taxes, but if there is a non-U.S. partner, this more clearly excludes the non-U.S. taxes. However, as a policy matter, the non-U.S. partner may argue that, despite the complication of foreign tax rules, such foreign taxes should be included as well, similar to the concept of including local taxes for partners living in a jurisdiction that assesses local income taxes.
Ability to show cause to increase tax distribution. The requisite distribution to all Members receiving a distribution shall be increased upon a demonstration by any Member, subject to the reasonable approval by the Manager, that the mandatory distribution provided by the preceding sentence is less than the combined federal, state and local tax burden attributable to his, her or its allocable share of the Company's income and the amount of any increase pursuant to this sentence shall be the amount necessary to ensure that the distributions to the demonstrating Member cover his, her or its tax burden.	Mandatory increase in tax distribution if Member reasonably demonstrates the original tax distribution was insufficient to cover its actual tax liability.	This provision is important for a partner who believes that the tax assumptions in the existing tax distribution provision may not cover the partner's actual taxes. This could be important, for example, for a service partner if the Section 710 proposed carried interest tax becomes law.
Discretionary refusal of a tax distribution. Notwithstanding anything to the contrary in this [Article], if, with respect to taxable income allocated to the Manager that is attributable to Manager Incentive Distributions (current or future), the Manager's Tax Liability with respect to the taxable year to which any such income allocation relates exceeds the Manager Incentive Distributions paid to the Manager for such taxable year, then the Company shall, at the option of the Manager, distribute an amount equal to the shortfall to the Manager (a "Special Tax Distribution"), [subject to cash flow limitation].	Allows Manager option to request tax distribution on carried interest income allocations if insufficient distributions under carried interest.	This is particularly helpful for a partner entitled to a carried interest where the partner wants the back-up liquidity of a tax distribution while maintaining the flexibility to decline the distribution if the partner can obtain other funds (or other offsetting deductions) outside of the partnership so as to allow partnership cash to return the preferred equity faster, and hence ultimately accrue more under the carried interest.
Withholding taxes. Federal, state, or local taxes withheld on behalf of a Member shall be treated as paid to such Member for purposes of calculating such Member's right to distributions under this paragraph [the tax distribution paragraph].	Reduces rights to tax distributions for taxes directly withheld and paid on behalf of the member.	Most tax withholding provisions already treat withholding taxes as a partner distribution, but this clarifies that the distribution counts to reduce a partner's rights to further tax distributions.

share may wish to have the tax distribution be optional, because the tax distribution reduces the cash paid to the capital partners, and the carried interest generally does not accrue until the capital partners receive a minimum preferred return on their equity. Thus, if there is a 10% preferred return, the carried interest partner may prefer to have the partnership cash used to pay down that 10% interest-like return (as long as the partner can find cheaper sources to pay tax on its phantom income). However, in an effort to maintain maximum liquidity options, the carried interest partner may negotiate for the right to receive a tax distribution at its discretion. Then, if the carried interest partner does not have other means to pay its taxes, it will not have a liquidity problem.

Exhibit 8 reviews provision language specifically addressing these additional concerns.

EXHIBIT 9
Baseline-Plus Samples

Sample drafting language is provided below for a variety of situations.

Cash flow limitation

Tax Distributions shall be limited to the extent the Company has cash available for distribution by the Company under the Act and subject to any applicable agreement to which the Company or any of its Subsidiaries is a party governing the terms of indebtedness for borrowed money and subject to the retention and establishment of reserves, or payment to third parties, of such funds as the Board of Managers deems necessary with respect to the reasonable business needs and obligations of the Company.

Quarterly estimated tax distributions

Tax Distributions shall be made not less than [five] days prior to the date on which such Member would be obligated to make estimated tax payments or file a timely income tax return (without extension), and the amount of distributions for estimated tax payments shall be determined by comparing cumulative tax distributions with respect to such tax year and year-to-date estimates or projections of net taxable income for such tax year, as reasonably determined by the Manager.

Tax rate

The highest combined marginal federal, state and local tax rates then applicable to an individual or corporation in any jurisdiction in which a Member is resident (with the state of residence of a Member that is a "flow-through" entity for tax purposes determined to be the state or states of residence of any direct or indirect owner of the entity who is responsible for paying taxes on such income) or the Company does business (whichever is higher), on income or gain of the category represented by such allocation (assuming the Member has no income or loss from sources other than the Company, and treating state and local taxes as fully deductible). In determining a Member's estimated tax liability, the Manager can disregard any items of tax deduction or loss if the Manager reasonably believes that the Member is not expected to be permitted to apply such items of deduction or loss to reduce its (or their) taxable income by reason of Section 212 of the Code or otherwise.

Reallocations and audit adjustments

In the event that there is a reallocation of income or loss among the Members or any other person as a result of audit adjustment, amended returns, or otherwise (the "Reallocated Items"), to the extent that tax distributions were originally made to any person with respect to such Reallocated Items, such persons who received distributions pursuant to paragraph [tax distribution paragraph] with respect to such Reallocated Items shall promptly return such distributions to the Company (or elect to reduce rights to future distributions from the Company). The persons who received an allocation of the Reallocated Items described immediately above shall be entitled to tax distributions pursuant to this paragraph in an amount equal to the distributions that would have otherwise been distributed to such person or persons under paragraph [tax distribution paragraph] had such amounts originally been allocated to such person or persons.

Ability to demonstrate need for additional tax distributions

The tax distribution to any Member shall be increased upon a demonstration by any Member, subject to the reasonable approval by the Manager, that the mandatory distribution provided by [the preceding sentence] is less than the combined federal, state and local tax burden attributable to the Member's allocable share of the Company's income, and the amount of any increase pursuant to this sentence shall be the amount necessary to ensure that the distributions to the demonstrating Member cover such Member's tax burden.

Conclusion

This article has sought to provide insight into the true complexities and benefits that are hidden inside tax distribution provisions. As others have previously observed, the scope and complexity of a tax distribution provision are truly formidable.[17] To provide some additional practical drafting advice for the real world, Exhibit 9 contains "baseline-plus" samples (based on the provisions analyzed above) that may have appeal among drafters willing to go beyond the basics in certain circumstances. ■

[17] See Cuff, "Drafting Tax Distribution Provisions," 38 J. Real Estate Tax. 10 (Fourth Quarter 2010).