**Purchasing a Partnership/LLC Interest: Tax Tip #1–Requiring Tax Distributions**

By Philip R. Hirschfeld

Tax Tip #1--Need for Mandatory Tax Distributions:

As background, most corporations pay tax on their income and then shareholders pay tax on dividends the corporation pays them, which is commonly referred to as subjecting the underlying income to a double tax. There are some exceptions to this rule such as for real estate investment trusts or S corporations, but it is generally the prevailing view. By contrast, partnerships or LLCs are a flow through entity for tax purposes. Income is not subject to tax at the partnership or LLC level, but rather the income passes through to the partners or members who then must pay the tax on their allocable share of such income.

Partnership tax status, thus, eliminates double taxation of the underlying income that is economically very helpful. However, each partner needs to have the cash to pay the tax due on that partner's allocable share of the income. Also, estimated taxes are required to be paid during the year on this income, so the partner cannot wait until year end to address this issue.

The determination of whether a partnership or LLC distributes cash to its partners or members is left to the managing general partner or member. The manager may want to not make any distributions to the partners and retain all cash in the partnership for capital improvements, repairs, creation of reserves or other valid business reasons. However, retaining all cash in the partnership leaves the partner with an economic problem in trying to find the cash to pay the tax on this income.

This financial dilemma can be addressed in the partnership or operating agreement or in a side letter that can mandate distributions to the partners, so that the partners can have the cash needed to pay their taxes -- a tax distribution requirement.

A review of the partnership or LLC operating agreement distribution provisions should first be made to see if they contain a tax distribution provision. Such provision will require a distribution of available cash to the partners or members so they can meet both their regular tax and estimated tax payment obligations. Such provision is very reasonable since a corporation would have to pay such taxes regardless of its business needs and the partners now have that legal obligation. If no tax distribution provision exists then inclusion of such provision by amendment of the partnership or operating agreement should be requested or if that may not be possible to obtain, a side letter

committing to make such tax distributions would be recommended.

An effective tax distribution provision should take into account that the determination of how much cash is needed depends upon each partner's own federal, state and local tax situation. If the provision is written to address the specific needs of each partner's tax situation then that may lead to an administrative burden in determining each partner's effective tax rate. If there are differing tax rates among the partners then tailoring distributions to the differing rates will lead to continuing administrative complications in keeping track of the amounts each partner gets, which also needs to be credited against future distributions to those partners.

A simpler approach is to negotiate up front a specific effective tax rate to use for all tax distributions based on the highest effective tax rate of any partner. For example, if one partner is an individual residing in high taxed New York City, an effective tax rate would be 50% based upon federal, state and local taxes. Therefore, 50% of their allocable share of the partnership’s taxable income should be distributed. This approach may reward some partners from lower tax jurisdictions, but this approach is much simpler to apply.

Apart from determining what tax rates to apply, another issue is how to deal with the situation when the partnership generates a tax loss in year one (for example, an $80 ordinary loss) and then taxable income in year two (for example, $100 ordinary taxable income). The tax distribution provision can be applied on a yearly basis with no regard to prior year losses and thus, mandate a distribution in year two to cover all the taxes on year two's $100 taxable income. In that case, the formula for this tax distribution would equal the Effective Tax Rate multiplied by the partner’s share of <u>current</u> Taxable Income. Alternatively, the tax distribution provision can be applied on a "cumulative" basis that combines all years together and then only provide for tax distributions once "aggregate" taxable income is generated. In that case, the formula for this tax distribution would equal the Effective Tax Rate multiplied by the partner’s <u>cumulative</u> share of all Taxable Income and Loss allocated to them since they first became a partner. By applying this alternate formula, a tax distribution would only be allowed in year two to cover taxes on $20 of taxable income (namely, $100 taxable income from year two minus $80 loss from year one). The partner may prefer applying this rule by using current taxable income, but the manager may insist that a cumulative approach be applied to allow more cash to remain at the partnership. .

These points can be used to draft an effective tax distribution provision so clients are not left with finding cash to pay taxes arising from their new partnership investment.

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