

Tax Geek Tips You Ought To Know

A PUBLICATION OF THE BALLARD SPAHR TAX GROUP

A PUBLICATION OF THE BALLARD SPAHR TAX GROUP

TAX DISTRIBUTION PROVISIONS – PRACTICAL CONSIDERATIONS

Partnerships and LLCs¹ are flow-through entities. This means that their owners have phantom income in any year in which the taxable income of the partnership/LLC allocated to them is less than the cash distributed to them. To deal with phantom income, many partnership and LLC agreements include tax distribution provisions. Generally, they provide that, even if a member/partner is not otherwise entitled to a cash distribution pursuant to the distribution scheme memorialized in the partnership/LLC agreement, a minimum distribution will be made to the member/partner to enable it to pay its taxes resulting from the income allocation.

A somewhat common tendency is to view tax distributions as “Monopoly money” – play money that doesn’t have real consequences. However, with existing combined U.S. federal and state income tax rates easily approaching, and in some cases exceeding, 50%², tax distributions can easily take up half or more than half of the cash flow of the partnership/LLC. This is why it is important to give careful consideration to (a) whether your agreement should provide for tax distributions, and if it does, (b) what specific points the drafting should address. Points that should be considered include:

- **Slower receipt of priority distributions.** If your client is entitled to a priority as to distributions, then the providing of tax distributions to all members likely slows the receipt of the full priority distribution by your client. With respect to each agreement, in considering whether to allow or require tax distributions, a comparison of when your client is entitled to distributions should be made with when your client is likely to be allocated income.
- **Advance or stand-alone distributions.** Unless it is clear that the tax distributions are an advance of distributions otherwise required to be made, the tax distributions likely distort the economic deal of the members/partners.

¹ LLCs with two or more members are treated for U.S. federal income tax purposes as partnerships, unless they have made a tax election to be treated as corporations. This memorandum addresses only LLCs that are taxed as partnerships.

² The current highest marginal U.S. federal income tax rate on the ordinary income of individuals is 39.6%. State income tax rates vary, but currently can be as high as 16%. The net investment income tax rate is 3.8%. The current U.S. federal corporate income tax rate is 34-35%. State corporate income tax rates vary, but currently can be as high as 12%.

- **Flow-through entity itself a member.** If your client is a member in an LLC, and is itself a flow-through entity, is the tax distribution provision worded broadly enough to require tax distributions to members that do not themselves have a tax liability as a result of the income allocations?
- **Actual rates versus assumed rates.** Often, for administrative ease, the state tax rate used in making tax distributions is the highest rate applicable to any member. Where an unusually high state tax rate is applicable to a member to whom a relatively small portion of the income is allocated, this should be given further thought.
- **Non-income taxes.** If your client is a member in an LLC and will, as a result of the allocations of income from the LLC, have liability for self-employment taxes or the net investment income tax, will the tax distribution cover those? Often, tax distributions cover only “income” taxes.
- **Carryforward of losses.** Does the tax distribution provision require that any losses previously allocated to a member be carried forward and be used to offset taxable income for the current year before tax distributions will be calculated? If so, and your client has already used up the earlier losses, it will have phantom income and not be entitled to a tax distribution.
- **At whose discretion?** Typically, tax distributions are made to the extent the partnership or LLC has “available cash” – which is often defined as all cash received by the partnership/LLC less required reserves, as determined by the manager. Where your client is not the manager, or in control of the manager, are there any controls in place as to the determination of required reserves?

Please reach out to one of the members of the Tax Group at Ballard Spahr LLP with any questions related to tax distributions and with help in structuring and drafting.

Saba Ashraf

Partner
ashrafs@ballardspahr.com
Tel 678.420.9372
Atlanta

Wendi L. Kotzen

Partner
kotzenw@ballardspahr.com
Tel 215.864.8305
Philadelphia

Jeffrey R. Davine

Partner
davine@ballardspahr.com
Tel 303.299.7312
Denver

Wayne R. Strasbaugh

Partner
strasbaugh@ballardspahr.com
Tel 215.864.8328
Philadelphia

Christopher A. Jones

Associate
jonesc@ballardspahr.com
Tel 215.864.8424
Philadelphia

Ballard Spahr

LLP