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Federal Tax ADVISORY ■

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Tax Distributions

It is very common for private equity investments to use partnerships to hold investments in portfolio companies. Because the investor/partners will owe tax on the partnership's income, the partnerships must make tax distributions to the investors to help cover the income tax liability of the partners so that the partners don't have to pay their taxes out of pocket.

The failure to pay close attention to the tax distribution section of an operating agreement can leave partners having to personally pay their resulting tax liability and even impact the economics of the overall deal.

The terms of the tax distribution provision depend on how the partnership allocates income among the partners. The vast majority of partnerships allocate their taxable income using targeted allocations (i.e., by generally doing a deemed liquidation of the partnership at the end of each year to determine what each partner would receive under the waterfall). When multiple classes of equity are involved, the ordering of the allocations is important. Generally, preferred investors get first allocations of taxable income (for their preferred return, not return of capital), and first losses are allocated to common (common is risking capital first, so they get allocated losses first).

The partnership's ability to make tax distributions is generally limited to available cash and subject to any limitations on distributions in other agreements of the partnership or its subsidiaries (e.g., credit agreements). It's always important to check the credit agreement to make sure any creditor limitation on tax distributions won't interfere with the tax distribution provision being negotiated by the partners in the operating agreement. Tax distributions are typically made at times to enable the partners to timely make their requisite estimated tax payments, and, generally, a single tax rate is assumed to apply to all the partners (even if a partner is a corporation).

The drafting for the amounts of tax distributions presents many choices. There are common inclusions and exclusions, but the manager will have many decisions to make. For example, tax distributions may be determined on a cumulative basis, meaning prior-year losses allocated to partners are taken into consideration when determining if the partners need cash for income in subsequent tax years.

Whether or not tax distributions are treated as advances against regular distributions of the return on investment can have an economic impact on the overall deal and becomes a business-level issue. Generally, tax distributions are treated as advances, and any differences in tax distributions made to each partner will ultimately just be timing differences (making the calculation of tax distributions not as important as when the tax distributions are not advances).

However, in some instances, for example, if a partner wants to realize the cash tax benefit of a tax basis step-up or one class of equity has a significant preferred return and is allocated all the operating income of the partnership, a partner may be able to negotiate for the tax distributions to not be treated as advances against the waterfall. Whenever tax distributions are not treated as advances, the partners need to understand how that treatment can potentially impact the economics of the deal. In such situations, the parties should also consider the circular issue of whether the tax distributions would create the need for additional tax distributions.

We recommend parties pay close attention to this language and understand it is certainly not general tax boilerplate language, like some may consider much of the tax allocation provisions to be.

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