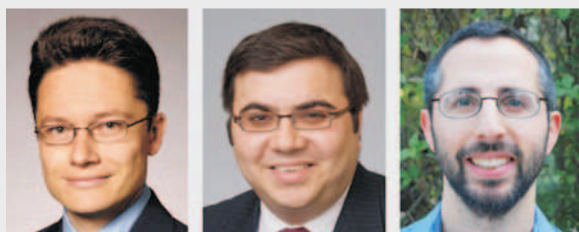
Playing With Blocks: Testing a Fund s Blocker Allocations

By Vadim Mahmoudov, Rafael Kariyev, and Daniel Backenroth



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This report examines a corporate blocker structure frequently used by private equity funds to shield some of their investors from some adverse tax consequences of investing in operating partnerships and other flow-through entities. Part I briefly reviews the typical reasons for creating a blocker structure and the types of investors who do and do not want to hold the underlying investment through a blocker structure. Part II describes a partial blocker structure that is often used by a private equity fund to reconcile the conflicting concerns of various constituencies among its investors. Part III considers whether the special allocations of partnership income required in that structure can withstand a challenge under the ''substantial economic effect'' principles of section 704(b).

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I. Why Use Blockers: *Cui Bono*?

One common reason for setting up a blocker structure arises when a private equity fund, structured as a partnership, makes a portfolio investment in a partnership or limited liability company that is conducting a U.S. trade or business. Some of the same issues arise when a fund invests in a partnership or another flow-through entity that is conducting a foreign trade or business. The following is a brief summary of how the typical investor constituencies in a fund can be affected by the fund's investment in that type of entity (an operating partnership).

A. Foreign Taxable Investors: ECI and Filings

A direct investment by a fund in an operating partnership that conducts a trade or business in the United States presents two major issues for a foreign taxable investor in the fund: (1) being taxed in the United States on income that is effectively connected with a U.S. trade or business (ECI), and (2) being obliged to file U.S. federal, and possibly state and local, income tax returns for its indirect interest in the operating partnership (the filing requirement). The fund's distributive share of effectively connected income generated by the operating partnership would flow up to the foreign investor. The fund's interest in the operating partnership, whether or not it generates positive ECI in any year, would also cause the fund (and the foreign investor in the fund) to be deemed to be engaged in a U.S.

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trade or business.[1] A foreign person that is engaged in a U.S. trade or business is required to file a U.S. federal income tax return, even if the person has no ECI to report.[2]

Many foreign investors are eager to avoid those consequences. Accordingly, the partnership agreements of many funds contain covenants requiring the fund's general partner to use some degree of care to avoid causing foreign investors to incur ECI or to become subject to the filing requirement. However, those covenants rarely prohibit funds from investing in operating partnerships in the United States. Instead, they typically require those investments to be structured in some manner that shields the foreign investors in a fund from directly incurring ECI.

The standard solution adopted by the private equity industry has been for funds to make those investments, in whole or in part, through an entity classified as a corporation for U.S. federal income tax purposes (a blocker). Notably, that solution generally is not designed to reduce the aggregate U.S. taxes borne by foreign investors on ECI from the operating partnership — the blocker will pay U.S. income tax (which a foreign investor would have otherwise paid directly) on its share of ECI — and no assurances are given to foreign investors in that regard.[3] Rather, the blocker is designed primarily to shift the obligation to pay U.S. taxes and the filing requirement to the blocker, enabling the fund's general partner to comply with its covenant to shield foreign investors from incurring those consequences.[4]

B. Foreign Governments: Section 892 Issues

Foreign governments are generally exempt under section 892 from U.S. tax on dividends, interest, and gains from the sale of U.S. stock and securities, including in some cases gain from the sale of stock of a U.S. real property holding corporation. A foreign government generally includes the integral parts and controlled entities of a foreign sovereign (a foreign government). A controlled entity is a juridical entity organized in the jurisdiction of the foreign sovereign that is wholly owned by the foreign sovereign, or by another controlled entity, and satisfies specified requirements.

Although a foreign government is generally exempt from U.S. tax, it is never exempt under section 892 on any income that arises from the conduct of a commercial activity. Current operating income from or gain from the sale of an operating partnership, whether engaged in a trade or business in the United States or abroad, would constitute commercial activity income (CAI). A foreign government that is a controlled entity and is, or is deemed to be, engaged in commercial activity anywhere in the world would automatically be a controlled commercial entity and lose entirely its exempt status under section 892, even for income that is not CAI.

Commercial activities of a partnership are attributed to foreign governments that are partners in the parntership.[5] On November 2 the IRS issued proposed regulations under section 892 that liberalize the existing rules in several respects.[6] Under the proposed regulations, a controlled entity will not be deemed to be engaged in commercial activities solely because it holds an interest as a limited partner in a limited partnership. To qualify for that exception, the partner or member generally cannot have rights to participate in the management and conduct of the partnership's business. The proposed regulations also provide that a controlled entity will not be a controlled commercial entity if it engages in only inadvertent commercial activity. The preamble to the proposed regulations states that taxpayers may rely on the proposed regulations until final regulations are issued.

C. U.S. Tax-Exempt Investors: UBTI Issues

Many U.S. tax-exempt investors (tax exempts) want to avoid or minimize unrelated business taxable income as defined under section 512. UBTI would include those investors' distributive share of income from an operating partnership (whether U.S. or foreign) in which a fund invests directly.[7] Like foreign investors, tax exempts often insist on covenants requiring funds to avoid incurring UBTI or to limit UBTI-generating investments to some percentage of total capital commitments. Once again, the standard fix for an investment in an operating partnership is to insert a blocker somewhere in the structure between the tax exempts and

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[1] *See* section 875(1).

[2] *See* reg. section 1.6012-1(b)(1)(i) and -2(g)(1)(i).

[3] It is often possible to reduce the blocker's taxable income by having the fund capitalize the blocker in part with debt and in part with equity, although the blocker's ability to deduct interest on that debt may be partially limited under section 163(j).

[4] The wisdom of foreign investors' continued insistence on that structuring, and fund managers devoting significant resources to comply with their demands, mostly to avoid the filing requirement, is beyond the scope of this report. Whether justified or not, many foreign investors remain reluctant to show up on the IRS's radar screen.

[5] *See* reg. section 1.892-5T(d)(3).

[6] REG-146537-06, *Doc 2011-23025*, *2011 TNT 213-7*.

[7] Importantly, some tax exempts such as state pension plans are less concerned about UBTI because they maintain that they are exempt under section 115. Under section 511(a), UBTI is taxable in the hands of tax exempts that are exempt "by reason of section 501(a)" or are state colleges or universities (or corporations wholly owned by state colleges or universities).

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the operating partnership. As a result, the blocker pays U.S. corporate income tax on its allocable share of any U.S. trade or business income from the operating partnership, which otherwise would have been taxed directly to the tax exempts. The blocker's after-tax earnings, if and when they are distributed to the fund and its investors, are received by the tax exempts in the form of dividends or payments on debt, none of which generally constitute UBTI.[8]

1. Blocker for U.S. operating partnership: An economic wash, or worse? Holding an investment in a U.S. operating partnership through a blocker might not save any money for a tax exempt (similar to the case of a foreign investor, described above) and may even be economically detrimental. For current operating income generated by the investment, the U.S. tax burden has simply shifted down from the tax exempt to the blocker, although leverage at the blocker level may reduce the tax leakage somewhat. However, for gain from the sale of the operating partnership, the tax exempt may be worse off than it would have been without the blocker. If the exit is structured as a sale of interests in the operating partnership by the blocker, the blocker will be subject to U.S. corporate income tax on the gain.[9] However, if the tax exempt had held and sold an interest in the operating partnership directly (or through a flow-through entity, such as the fund), the gain on sale generally will not be treated as UBTI, except to the extent the sold interest constituted debt-financed property under section 514(b) or was attributable, through the operation of section 751(a), to inventory or other property held primarily for sale to customers in the ordinary course of business or to section 1245 property (as defined in section 1245(a)(3)) or section 1250 property (as defined in section 1250(c)).[10]

For those reasons, in our experience tax exempts frequently do not elect to invest in U.S. operating partnerships through blockers when given a choice between doing so and participating in the investment directly through the fund. However, some tax exempts may still prefer a blocker structure if they are not otherwise filing U.S. income tax returns for UBTI and wish to avoid the filing requirement.

2. Blocker for foreign operating partnership: A home run? Tax exempts may well desire to hold any investment in a foreign operating partnership through a blocker, as long as the foreign tax treatment of the underlying income is not adversely affected by interposing the blocker. If the blocker can be organized in a foreign tax haven, it might not pay any U.S. or other taxes on income from the operating partnership. Thus, there is no blocker-level economic leakage, other than negligible formation and maintenance costs. Assuming the blocker's existence is respected for U.S. tax purposes, the tax exempts have successfully converted UBTI from the operating partnership into tax-exempt dividend income by routing that income through the blocker.[11]

D. U.S. Taxable Investors: No Blocker, Please

Another major investor constituency in a typical fund consists of individuals and corporations that are U.S. taxpayers (U.S. taxables). This usually includes some or all members of the fund's management team, who receive a portion of the fund's

[8]Section 512(b)(13) treats as UBTI specified payments, including interest, received by a tax exempt from a controlled entity. However, for a blocker to be treated as controlled under that provision, the tax exempt would need to own a greater than 50 percent interest in the blocker. That provision is rarely relevant in the context of a fund, whose ownership is usually widely dispersed.

[9]Even if the exit is a sale of blocker stock, the tax exempt bears some indirect tax leakage. The buyer would not get a step-up in the basis of the operating partnership's assets by buying blocker stock, whereas it could have obtained a step-up by purchasing direct interests in the operating partnership with a section 754 election. Therefore, a well-advised buyer would likely discount the purchase price that it otherwise would have been willing to pay for a direct interest in the operating partnership, by some figure approximating the lost present value of potential amortization and depreciation deductions. Also, the buyer may further reduce its purchase price if there are any potential liabilities, *e.g.*, corporate tax exposures, at the blocker level.

[10]Section 512(b)(5) generally exempts from UBTI treatment gains from the sale of property. Section 512(b)(5) is overridden by the recapture rules of sections 1245 and 1250. *See* reg. sections 1.1245-6(b) and 1.1250-1(c)(2). For a sale of a partnership interest, section 751(a) treats gain attributable to unrealized receivables (which includes recapture) and inventory items as not being gain from the sale of a capital asset. It is unclear whether that means that section 751(a) would result in all that gain being treated as UBTI.

[11]There has been some debate about the potential ability of the IRS to ignore the blocker and treat the fund or the tax exempt as earning UBTI directly from the operating partnership, for example under section 269 or the economic substance doctrine. *See, e.g.*, Andrew W. Needham, "A Guide to Tax Planning for Private Equity Funds and Portfolio Investments (Part 2)," *Tax Notes*, May 27, 2002, p. 1381, *Doc 2002-12742*, or *2002 TNT 103-36*; and David S. Miller, "How U.S. Tax Law Encourages Investment Through Tax Havens," *Tax Notes*, Apr. 11, 2011, p. 167, *Doc 2011-4766*, or *2011 TNT 70-3*. Those theories are beyond the scope of this report. However, we note that to date, the IRS has not shown any desire to pursue those theories. *See, e.g.*, LTR 201116014, *Doc 2011-8705, 2011 TNT 79-36*; LTR 201120017, *Doc 2011-10941, 2011 TNT 99-46*; and David H. Shapiro and Jeffrey W. Maddrey, "IRS Implicitly Rules on Economic Substance Doctrine and Blockers," *Tax Notes*, Mar. 21, 2011, p. 1461, *Doc 2011-4752*, or *2011 TNT 55-6*.

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income (returns on their own capital investment and carried interest in the limited partners' investment) through the general partner entity or another affiliated flow-through vehicle. In general, holding an operating partnership investment through a blocker is detrimental to the U.S. taxables.

For a U.S. operating partnership, interposing the blocker results in an additional layer of tax on the operating partnership's current income, or on any gain from a sale of interests in the operating partnership, in the hands of the blocker. It does not matter whether the blocker is a U.S. or foreign corporation — in the latter case, income from the operating partnership is ECI that still attracts U.S. corporate income tax. In fact, using a foreign corporation as the blocker is worse in that case. The foreign blocker will incur branch profits tax under section 884 to the extent it pays out dividends, including dividends attributable to its U.S. shareholders. However, a U.S. blocker would not be subject to branch profits tax. Instead, its shareholders would be subject to withholding taxes on dividends, but that withholding would not apply to the portion of the dividend attributable to U.S. shareholders.

For a foreign operating partnership held through a foreign blocker,[12] the consequences to U.S. taxables are generally less severe, unless the blocker is a controlled foreign corporation or a passive foreign investment company.[13] However, interposing the blocker is still suboptimal for them. For example, losses incurred by the operating partnership would not flow through to U.S. taxables. Nor would foreign tax credits for any foreign taxes incurred by the operating partnership, except for some U.S. corporate investors eligible for an indirect FTC under section 902.

One scenario in which some U.S. taxables might prefer a blocker would be an operating partnership that operates in many states. A small investor that otherwise would not be filing tax returns in all those states may be overwhelmed by the additional administrative burden caused by that type of investment.[14] However, large U.S. taxables presumably already file returns in most states and would not want to trade administrative complexity for an extra layer of income tax on their economic returns from the investment.

II. The 'Partial Blocker Solution: Split the Baby

As shown above, while foreign investors and some tax exempts may often want a fund to hold their investment in an operating partnership through a blocker, that structure would be detrimental to the U.S. taxables and perhaps to many tax exempts. One structure frequently used by funds to address those competing concerns is the so-called partial blocker solution.[15]

A. Description of the Partial Blocker Structure

In the partial blocker structure, all the fund's investors contribute capital to the fund for the operating partnership investment. A portion of the contributed capital, attributable to investors who do not wish to invest through a blocker (non-blocker partners), is invested by the fund in an intermediate holding entity treated as a partnership for U.S. tax purposes (a splitter). The remainder of the contributed capital, attributable to investors who wish to invest through a blocker (blocker partners), is invested by the fund entirely in equity, or in part equity and part debt, of a wholly owned blocker. The blocker then contributes its portion of the capital to the splitter, which has two partners: the fund and the blocker. The splitter then invests in the operating partnership.

The splitter generally allocates all its income from the operating partnership (direct income) to the fund and the blocker pro rata in accordance

[12]It rarely makes sense to use a U.S. corporation as a holding company for an investment in a foreign operating partnership.

[13]A CFC is a foreign corporation that has more than 50 percent of its stock owned, by vote or value, by U.S. persons that own 10 percent or more of its voting stock. Section 957(a). Those 10 percent U.S. shareholders are required to include currently their share of the foreign corporation's subpart F income, and some or all of their gain from the sale of stock of the foreign corporation may be characterized as dividend income. *See* sections 951 and 1248.

A PFIC is a foreign corporation that meets the following test: Either 75 percent or more of its gross income is passive income, or 50 percent or more of its assets (by value or tax basis) produce passive income. Section 1297(a). Any gain recognized by a U.S. shareholder from a sale of stock of that foreign corporation, along with some distributions therefrom, would be taxed under section 1291 at ordinary income rates and would also be subject to an interest charge, unless the U.S. shareholder makes an election under section 1295 to treat the corporation as a qualified electing fund or makes an election under section 1296 to mark to market. A U.S. shareholder that makes an election under section 1295 is required to include currently his share of the corporation's ordinary earnings and net capital gain, but net losses do not flow up.

[14]Many states allow the fund or a lower-tier partnership to file composite returns on behalf of individuals and some other taxpayers, which may relieve this burden for some investors.

[15]A variety of other structures can be and have been used by funds to invest in operating partnerships, including alternative investment vehicles and parallel funds, which are beyond the scope of this report. The partial blocker structure is a relatively simple solution because it uses fewer additional entities and, unlike some other alternatives, does not present venture capital operating company issues for ERISA-sensitive investors.

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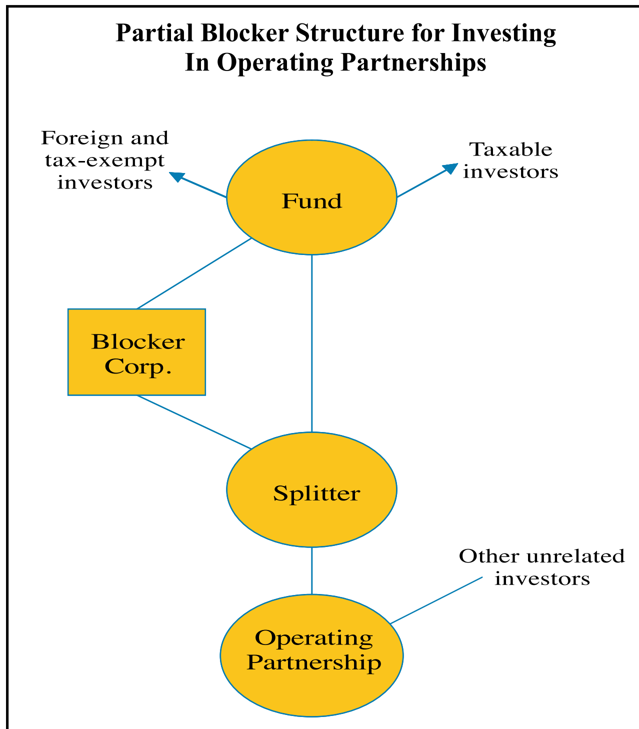
with capital contributions.[16] To the extent the blocker is a taxpayer in the United States or other jurisdictions, the portion of the income allocated to the blocker bears a layer of corporate-level tax in the hands of the blocker, with only the after-tax amount being distributable to the fund as a dividend or a payment on debt (blocker distributions).



The allocation provisions of the fund's partnership agreement typically provide that the direct income is allocated 100 percent to the non-blocker partners and that the blocker distributions are allocated 100 percent to the blocker partners (the special allocation). If the exit from that investment is structured in part as a sale of blocker stock (rather than its partnership interest in the splitter), the special allocation also typically provides that sale proceeds attributable to blocker stock are allocated 100 percent to the blocker partners, while proceeds attributable to a direct sale of splitter equity by the fund are allocated 100 percent to the non-blocker partners.[17] Accordingly, the blocker partners bear 100 percent of the economic cost of the blocker structure, including corporate-level taxes and any maintenance expenses of the blocker, such as the cost of preparing its annual tax returns and financial statements.[18]

Typically, the fund's partnership agreement contemplates the potential use of the partial blocker structure and the special allocation before any investments are made. Affected partners either irrevocably elect to be blocker partners in advance of any investments being made, or retain the right to elect in or out of being blocker partners in the future, when an investment in an operating partnership is about to be made.

B. Tax Issues

The partial blocker structure is primarily designed to avoid the incurrence of ECI, CAI, or UBTI by blocker partners, while also allowing non-blocker partners to avoid holding their piece of the investment through the blocker. As discussed below, there is some risk that the special allocation is not respected, which would frustrate that key objective.

Even if the structure's primary objective is achieved, it does not eliminate the filing requirement. Because the foreign investors are partners in the fund, which holds an indirect interest in the operating partnership through another passthrough entity (the splitter), they are still technically deemed engaged in a U.S. trade or business despite having no ECI allocated to them. However, if there is no taxable income to report, a failure to file a U.S. income tax return seems largely academic.[19] One

[16]The general partner's carried interest may be allocated in a variety of ways in this structure, depending on structural constraints and the business deal between the investors and the general partner. Typically, it is allocated entirely to the fund or the general partner, assuming the fund's management team consists of U.S. taxables who do not wish to run their carried interest through the blocker.

[17]Because of the blocker discount described in note 7, *supra*, this may result in a lower economic return from the investment for the blocker partners. Thus, if the investment is evenly split between the blocker and the fund as a direct investor in splitter equity, a buyer is likely to pay a lower price for blocker stock than for splitter equity.

[18]In most cases the general partner's carried interest is computed by reference to 20 percent of the splitter's total income — that is, without regard to any costs incurred at the blocker level — and is distributed by the splitter directly to the fund or the general partner, thus bypassing the blocker. If the exit involves a sale of blocker stock subject to blocker discount by the buyer, the computation of carried interest becomes more complex. For the sake of simplicity, the analysis that follows will focus on allocations between blocker partners and non-blocker partners other than the general partner, ignoring the carried interest.

[19]If a foreign investor fails to file a U.S. income tax return for any year, the statute of limitations for assessment and collection of the U.S. income tax that may be imposed on the investor for that year will never expire. Section 6501(c)(3). The filing by the foreign investor of a protective return showing no income, however, will start the statute running, although in this case, the statute may be extended from three to six years if there is a substantial omission of income. Reg. sections 1.874-1(b)(6) and 1.882-4(a)(3)(vi); FSA 3809 (June 11, 1996); and section 6501(e). Note also that if the IRS were to successfully argue that some

(Footnote continued on next page.)

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wonders how many foreign investors actually comply with the filing requirement in that case, or even realize that they have an issue, if all they get from the fund is a Schedule K-1 that does not include any ECI.

For a foreign government, the problem is more serious. Putting aside the filing requirement, being a partner in a tiered partnership structure that feeds into the operating partnership could technically cause the foreign government to be treated as being engaged in a commercial activity even if no CAI is allocated to it.[20] For a foreign government that is a controlled entity, that structure could result in it becoming a controlled commercial entity and thereby losing all entitlement to the benefits of section 892. For that reason, well-advised foreign governments often object to the use of the partial blocker structure and insist on more elaborate structures.

III. Can the IRS Challenge the Allocation?

A. The Applicable Section 704(b) Rules

The above discussion leads us to the key question: Does the special allocation work?

Under the "substantial economic effect" principles of section 704(b), an allocation will generally be respected if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences. Even if an allocation satisfies that test, however, it may not be respected if it fails the "after-tax test."[21] An allocation fails the after-tax test if, when it is included in the partnership agreement, on a present-value basis (1) the after-tax consequences of at least one partner may be enhanced compared with that partner's after-tax consequences in the absence of the allocation; and (2) there is a strong likelihood that the after-tax consequences of no other partner will be substantially diminished.[22]

If an allocation flunks the after-tax test, the regulations require reallocation in accordance with the manner in which the partners have agreed to share any economic benefit or burden corresponding to the income, gain, loss, deduction, or credit (or item thereof) that is being allocated (the partners' interests in the partnership).[23] The partners' interests in the partnership are determined taking into account all the facts and circumstances, including the partners' relative contributions to the partnership and their interests in economic profits and losses.[24]

Example 5 of the section 704(b) regulations demonstrates the application of the after-tax test.[25] In a simplified and slightly modified version of that example, an individual who expects to be in the 35 percent marginal tax bracket (X) and an individual who expects to be in the 15 percent marginal tax bracket (Y) form PRS, an investment partnership. Over the next three years, there is a strong likelihood that PRS will realize $100 of tax-exempt interest and $100 of taxable interest from its securities. X and Y make equal contributions to PRS and agree to share equally in gains and losses from the sale of PRS's securities. X and Y further agree that they will allocate, and distribute cash derived from, tax-exempt interest 85 percent to X and 15 percent to Y, and that they will allocate, and distribute cash derived from, taxable interest 100 percent to Y.

The after-tax test requires a comparison of the after-tax consequences to the partners, taking into account the allocation being tested, against a baseline situation in which the allocation is not included in the partnership agreement. The applicable baseline, which was clarified in amendments to the section 704(b) regulations finalized in 2008 (the 2008 regulations),[26] is the after-tax consequences that would result if the applicable income, gain, loss, deduction, or credit (or item thereof) were allocated in accordance with the partners' interests in the partnership, determined as if the allocation being tested were not contained in the partnership agreement.[27] Since X and Y made equal contributions to PRS and they agreed that they would share equally in gains and losses from the sale of PRS's securities, Example 5 posits that X and Y each have a 50 percent interest in PRS's taxable and tax-exempt interest income and uses 50/50 sharing as the baseline.

Without the allocation, over three years X is expected to be allocated 50 percent ($50) of PRS's tax-exempt interest and 50 percent ($50) of PRS's taxable interest, which would yield X $82.50 ($100 - $50 * 35 percent) after tax. With the allocation, over three years X is expected to be allocated $85 of

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portion of the income from the operating partnership should be allocated to foreign investors, those investors may then be prevented from offsetting gross income allocated to them from the operating partnership with their share of the operating partnership's deductions. *See* sections 874(a) and 882(c)(2).

[20]Reg. section 1.892-5T(d)(3).

[21]Reg. section 1.704-1(b)(2)(iii)(a). We will assume throughout this report that the other requirements of the substantial economic effect rules of section 704(b) are satisfied.

[22]The regulations also contain rules relating to shifting and transitory allocations that are not germane to our discussion. *See* reg. section 1.704-1(b)(2)(iii)(b) and (c).

[23]Reg. section 1.704-1(a)(1)(i).

[24]Reg. section 1.704-1(b)(3)(ii).

[25]Reg. section 1.704-1(b)(5), Example 5. Example 5 refers to individuals I and J. To avoid confusion with the personal pronoun, this report refers to them as X and Y.

[26]*See* T.D. 9398, *Doc 2008-10900, 2008 TNT 97-6*.

[27]Reg. section 1.704-1(b)(2)(iii)(a).

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tax-exempt interest and $0 of taxable interest, which would yield X $85 after tax. Therefore, X's after-tax consequences will be enhanced as a result of the allocation. However, there is a strong likelihood that the after-tax consequences to Y will not be substantially diminished as a result of the allocation. Without the allocation, Y is expected to be allocated 50 percent ($50) of PRS's tax-exempt interest and 50 percent ($50) of PRS's taxable interest, which would yield Y $92.50 ($100 - $50 * 15 percent) after tax. With the allocation, Y is expected to be allocated $15 of tax-exempt interest and $100 of taxable interest, which would yield Y $100 ($115 - $100 * 15 percent) after tax. The allocation therefore flunks the after-tax test, and the interest income may need to be reallocated.

If an allocation flunks the after-tax test, a reallocation of the income of the partnership is required to be made in accordance with the partners' interests in the partnership. However, for that purpose, the partners' interests in the partnership are determined taking into account the economic (but not the tax) effect of the allocation being tested. Therefore, to the extent an allocation being tested actually affected the dollar amounts received by the partners from the partnership before tax, that allocation is taken into account in determining the partners' interests in the partnership.[28]

If over three years PRS in fact receives $50 of tax-exempt interest and $50 of taxable interest, X and Y's interests in the interest income of PRS should therefore be determined on the basis of the total interest income that was distributed to them by PRS. Because in the example X received $85 and Y received $115 of interest income, X's interest in the interest income would be determined to be 42.5 percent and Y's interest in the interest income would be determined to be 57.5 percent. X would be allocated 42.5 percent of each class of interest income, and Y would be allocated 57.5 percent of each class of interest income. That leads to a considerably worse outcome for X than if the allocation had not been a part of the agreement and all income had in fact been shared 50/50, as X would end up, after tax, with $70.13 ($85 - $42.5 * 35 percent).

The following examples demonstrate the potential application of the section 704(b) substantiality rules to the special allocation.

[28]T.D. 9398 ("The reallocation did not change the percentages in which the partners shared total income, but rather, required that each item of income (that is, tax-exempt income and taxable interest and dividends included in total income) be shared in those same percentages").

B. Example A: U.S. Operating Partnership

Assume splitter is owned 50 percent by the fund (and, indirectly, its non-blocker partners) and 50 percent by the blocker (and, indirectly, the fund and its blocker partners). Splitter owns an interest in a U.S. operating partnership, which allocates and distributes to splitter $40 net income from its U.S. trade or business. Splitter allocates and distributes $20 of that income to the fund and $20 to the blocker, which pays $7 of corporate income tax and has only $13 left to distribute to the fund as a dividend for the benefit of the blocker partners. The entire $13 is distributed by the blocker as a dividend, not as a payment on debt. Under the special allocation, the fund allocates $20 of direct income to the non-blocker partners and $13 of blocker distributions to the blocker partners.

Before testing the substantiality of the special allocation under the after-tax test, one must establish a baseline allocation for the comparison.

1. Potential reallocation #1: Provide pro rata slice of each income type to each partner, but respect economics. The easiest path to establishing an alternative baseline would be to start with the actual economics of each partner in the fund, without regard to the tax treatment of any category of income. Here, blocker partners are entitled to receive $13 from the fund and non-blocker partners are entitled to receive $20. The fund earned a total of $33, which was shared 60.6 percent (20/33) by non-blocker partners and 39.4 percent by blocker partners. Accordingly, one could test the special allocation by allocating both direct income and blocker distributions 60.6 percent to non-blocker partners and 39.4 percent to blocker partners, because that would result in the same pretax dollars that they actually received under the partnership agreement. After reallocating the income in that manner, the after-tax consequences to the partners would be determined and compared with the after-tax consequences of the special allocation.

Assuming there are only two partners — a U.S. taxable who is an individual and a non-blocker partner, and a tax exempt that is subject to UBTI rules and is a blocker partner — the test should produce approximately the results shown in Table 1.

Under that interpretation of the after-tax test, the special allocation should be respected. While the tax exempt clearly is better off under the special allocation, the U.S. taxable is significantly worse off.

2. Potential reallocation #2: Revise economics. The testing approach outlined above can be challenged as not complying with the approach taken in Example 5 in the regulations and the two-step method prescribed by the 2008 regulations. One can argue that the 60.6 percent/39.4 percent ratio should not

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Tab e 1		
	U.S. Taxable Individual	Tax Exempt
Tax rate on direct income	35%	35%
Tax rate on blocker distributions	15%	0%
Special allocation		
Direct income	$20.00	$0.00
Blocker distributions	$0.00	$13.00
Tax at the partner level	-$7.00	$0.00
After-tax cash (a)	**$13.00**	**$13.00**
Baseline allocation (60.6%/39.4%)		
Direct income	$12.12	$7.88
Blocker distributions	$7.88	$5.12
Tax at the partner level		
Tax on direct income	-$4.24	-$2.76
Tax on blocker distributions	-$1.18	$0.00
After-tax cash (b)	**$14.58**	**$10.24**
Difference (a-b)	**-$1.58**	**$2.76**

be the baseline, but rather the ratio to be used to reallocate taxable income at the end, after the special allocation has been determined to flunk the after-tax test. In Example 5, the parties are first inferred to have agreed to share all income 50/50 before adopting the special allocation. Their implicit deal requires the income to be tested under a 50/50 baseline and then reallocated 64/36 (57.5/42.5 in our simplified version above). Starting with the pro rata allocation as the baseline, 64/36 in that example, would be putting the cart before the horse. It would also indirectly validate the special allocation — which was concocted to disguise the underlying after-tax economic deal between the parties.[29]

Applying those arguments to our Example A — and assuming that the parties' intended after-tax economic deal was to share income from the operating partnership 50/50 — could result in a test that produces approximately the results shown in Table 2.

Under that view of the world, the special allocation flunks the after-tax test because it made the U.S. taxable better off and did not make the tax exempt any worse off, compared with the baseline allocation.

But that does not end the analysis. A typical fund includes a variety of partners with different tax profiles. The special allocation would flunk the

[29]T.D. 9398. Curiously, a recent court decision that attempted to apply the after-tax test analyzed Example 5 using 64/36 as the baseline and still concluded that the IRS should win in that case. *TIFD III-E Inc. v. United States*, 342 F. Supp.2d 94 (D. Conn. 2004), *Doc 2004-21384*, *2004 TNT 214-17*, *rev d*, 459 F.3d 220 (2d Cir. 2006), *Doc 2006-14691*, *2006 TNT 150-8*. That decision preceded the issuance of the 2008 regulations.

Tab e 2		
	U.S. Taxable Individual	Tax Exempt
Tax rate on direct income	35%	35%
Tax rate on blocker distributions	15%	0%
Special allocation		
Direct income	$20.00	$0.00
Blocker distributions	$0.00	$13.00
Tax at the partner level	($7.00)	$0.00
After-tax cash (a)	**$13.00**	**$13.00**
Baseline allocation (50%/50%)		
Direct income	$10.00	$10.00
Blocker distributions	$6.50	$6.50
Tax at the partner level		
Tax on direct income	-$3.50	-$3.50
Tax on blocker distributions	-$0.98	$0.00
After-tax cash (b)	**$12.02**	**$13.00**
Difference (a-b)	**$0.98**	**$0.00**

after-tax test only if *no* partner's after-tax economics were significantly diminished by it. Using the same baseline, consider in Table 3, which shows the effect of the special allocation on a foreign individual, who is also likely to be one of the blocker partners.

Tab e 3		
	U.S. Taxable Individual	Foreign Taxable Individual
Tax rate on direct income	35%	35%
Tax rate on blocker distributions	15%	30%[a]
Special allocation		
Direct income	$20.00	$0.00
Blocker distributions	$0.00	$13.00
Tax at the partner level	-$7.00	-$3.90
After-tax cash (a)	**$13.00**	**$9.10**
Baseline allocation (50%/50%)		
Direct income	$10.00	$10.00
Blocker distributions	$6.50	$6.50
Tax at the partner level		
Tax on direct income	-$3.50	-$3.50
Tax on blocker distributions	-$0.98	-$1.95
After-tax cash (b)	**$12.02**	**$11.05**
Difference (a-b)	**$0.98**	**-$1.95**
[a]Assuming the foreign investor is not eligible for a reduced rate of U.S. withholding tax on dividends under any treaty.		

Accordingly, even with a 50/50 baseline, the after-tax test produces a partner who is disadvantaged by the special allocation. This demonstrates that the special allocation has real economic effect, and the 50/50 baseline would not accurately replicate the economic deal between the partners.

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Further, testing the arrangement in Example A by using a 50/50 baseline proves too much. The parties in that case did not in fact agree on a 50/50 sharing of the partnership's income across the board. The non-blocker partners wanted no part of the blocker and insisted on being allocated a passthrough portion of the direct income from the underlying operating partnership. That would have been their deal with or without the blocker or the blocker partners in the structure — for example, if the blocker partners and the non-blocker partners had made the investment through two separate sister partnerships (which obviously would have eliminated any need for a special allocation inside either partnership). However, the blocker partners agreed to bear any costs of the blocker, including corporate-level taxes and maintenance expenses, in exchange for being entitled solely to the blocker distributions. Each partner would have insisted on that economic deal regardless of the tax profile of the other partners or the overall population of the partnership.

That is a different case from Example 5 in the regulations, in which the partners started out with a general 50/50 deal and then adjusted the allocations for specified streams of income to minimize their aggregate tax burden, based on the interaction of those income streams with their respective tax characteristics (that is, their different marginal tax rates). In effect, the parties altered their basic economic deal in an attempt to achieve an even better after-tax deal at the treasury's expense.[30] By contrast, the fund's special allocation is frequently a part of the partnership agreement from the outset, before any investments are made or the entire population of the partners is even known (because a fund typically acquires investors in stages through multiple closings). Thus, when the special allocation becomes a part of the partnership agreement, it is usually not known whether any investments in operating partnerships will be made or whether there is a strong likelihood that the special allocation will be harmless to each partner.

In light of the foregoing, we believe the better answer is that the special allocation in Example A should be respected under the section 704(b) substantiality rules. And, even if the special allocation somehow fails the substantiality rules, that simply raises the question of how income should be allocated under the partners' interests in the partnership test. We believe the special allocation is the allocation that conforms with the partners' interests in the partnership in this case because it represents the real economic deal between the partners.[31]

C. Example B: Foreign Operating Partnership

Assume the same facts as in Example A, except that the operating partnership is not engaged in any U.S. trade or business. Instead, it is a foreign entity that is treated as a partnership for U.S. tax purposes and is engaged in UBTI-generating business activities overseas. Assume further that the blocker in this case is a Bermuda corporation that does not pay any tax on its income and that foreign taxes imposed in the jurisdiction of the operating partnership are zero or negligible. Ignoring any foreign taxes, the splitter earns $40 net income from the operating partnership. The splitter allocates and distributes $20 of that income to the fund and $20 to the blocker, which pays no tax and has $20 left to distribute to the fund as a dividend for the benefit of the blocker partners. Under the special allocation, the fund allocates $20 of direct income to the non-blocker partners and $20 of blocker distributions to the blocker partners.

If the special allocation is respected in that case, a tax-exempt blocker partner would end up with $20 after-tax cash, while a U.S. taxable individual non-blocker partner would end up with $13 after-tax cash. Example B is a more likely candidate for a successful challenge under the after-tax test.[32] Reallocating the direct income and blocker distributions 50/50 across the board would, as shown in Table 4, clearly make the tax exempt worse off, while the U.S. taxable would be indifferent: Unlike Example A, both streams of income are taxable at ordinary income rates because dividends from a Bermuda corporation are not eligible for qualified dividend income treatment under section 1(h)(11).

Despite that result, the same arguments outlined in Example A above apply here. The special allocation represents the true economic deal of the parties (for example, if there were any corporate-level liabilities at the blocker level, the blocker partners

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[30]For further discussion of Example 5, see, *e.g.*, Gregg D. Polsky, "Deterring Tax-Driven Partnership Allocations," 64 *Tax Law.* 97 (2010).

[31]For further discussion on this topic, see Joel Scharfstein and Andrew Falevich, "Ruminations on Substantiality Under the Section 704(b) Regulations," in *PLI Tax Law and Estate Planning Course Handbook* 914, at 83-1 (2010); Needham, *supra* note 9, at 1392.

[32]Even after factoring in any foreign taxes paid or deemed paid by the fund on direct income, the special allocation would still likely be subject to a substantiality challenge under the after-tax test. If respected, the special allocation would result in all those FTCs being allocated to the U.S. taxables. *See* reg. section 1.704-1(b)(4)(viii). That tends to result in both the tax exempts and U.S. taxables being better off with the special allocation compared with the 50/50 baseline allocation.

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Tab e 4		
	U.S. Taxable Individual	Tax Exempt
Tax rate on direct income	35%	35%
Tax rate on blocker distributions	35%	0%
Special allocation		
Direct income	$20.00	$0.00
Blocker distributions	$0.00	$20.00
Tax at the partner level	-$7.00	$0.00
After-tax cash (a)	**$13.00**	**$20.00**
Baseline allocation (50%/50%)		
Direct income	$10.00	$10.00
Blocker distributions	$10.00	$10.00
Tax at the partner level		
Tax on direct income	-$3.50	-$3.50
Tax on blocker distributions	-$3.50	$0.00
After-tax cash (b)	**$13.00**	**$16.50**
Difference (a-b)	**$0.00**	**$3.50**

would have had to bear them) and was not designed to take advantage of any partner's tax attributes. Had the U.S. taxable and the tax exempt invested in the operating partnership through separate funds, with the tax exempt investing through a blocker, they would have achieved the same result that was produced by the special allocation. (In fact, that is the structure typically used by hedge funds, with tax exempts investing through an offshore feeder blocker that sits above a master fund that may generate UBTI. Because the blocker is above the fund, that structure eliminates any need for a special allocation inside the fund.) Thus, they should not be penalized for simply pooling their investment in the same partnership and inserting the blocker below, rather than above, the fund. Moreover, often tax exempts are required to elect to invest through blockers in advance, on the formation of the fund, for both U.S. and foreign operating partnerships. In that case, the special allocation should meet the after-tax test because when the special allocation is added to the fund's partnership agreement, it is not known what investments the fund will make.

Nevertheless, Example B seems more troublesome because no partner is made worse off by the special allocation, while the tax exempt is clearly advantaged by it. Funds would be well-advised to use separate alternative investment vehicles to make that investment.

D. De Minimis Rule to the Rescue?

In many fund structures, the after-tax test may simply be inapplicable. The 2008 regulations added an exception stating that tax attributes of de minimis partners need not be taken into account.[33] A de minimis partner is any partner, including a look-through entity that directly or indirectly owns less than 10 percent of the capital *and* profits of a partnership, that is allocated less than 10 percent of each partnership item of income, gain, loss, deduction, and credit. A typical fund's population of investors is widely dispersed so that no single limited partner owns 10 percent of the fund.

However, one partner that is entitled to more than 10 percent of the capital or profits is the general partner vehicle for its carried interest.[34] Assuming that most of the members of the general partner are U.S. individuals, the analysis described above in Example A using the second alternative (the 50/50 baseline allocation approach) would still potentially apply. However, the fund may still be able to point to its foreign investors as a constituency that is harmed by the special allocation under that reading of the after-tax test.[35] The after-tax test may be inapplicable to the general partner if the general partner's economic interests in the operating partnership investments are siphoned off at the splitter level, where there are no special allocations. However, that may introduce additional complexities — for example, ERISA issues.

IV. Conclusion

Although the special allocation raises thorny issues, we believe that in most cases it should be respected for section 704(b) purposes, either because it satisfies the after-tax test or because it complies with the partners' interests in the partnership. However, the technical analysis depends on the facts of the particular fund and operating partnership involved, and it becomes particularly challenging for a foreign operating partnership.

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[33]Reg. section 1.704-1(b)(2)(iii)(e). On October 24 the IRS and Treasury issued proposed regulations that would remove the de minimis rule. If that proposal is adopted, it would make this part of our discussion obsolete. *See* REG-109564-10, *Doc 2011-22310*, *2011 TNT 206-19*.

[34]Note that although the general partner itself is typically a look-through entity and has no tax attributes, the regulations generally take into account the attributes of a look-through partner's direct and indirect owners. *See* reg. section 1.704-1(b)(2)(iii)(d). That seems to apply regardless of whether those owners themselves would be de minimis partners of the look-through partner or the partnership.

[35]One could speculate whether the de minimis rule can be used as a dagger by the IRS by not allowing the fund to demonstrate that the special allocation is worse for de minimis foreign limited partners. However, that would be turning the de minimis rule on its head, because it was designed to be taxpayer-friendly by reducing compliance burdens. *See* T.D. 9398. Moreover, the regulation is quite clear that de minimis partners "need not be taken into account" — nowhere does it suggest that they *cannot* be taken into account.

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