

MEMORANDUM

August 3, 2010

TO: Harry Haynsworth

Cc: Carter Bishop
Dan Kleinberger

FROM: Steve Frost

Re: COMMENT RE PROFIT AND LOSS ALLOCATIONS

At the annual meeting you and I discussed the benefit of a comment addressing why uniform acts do not include default allocation and capital account rules. I prepared the following suggested comment for your consideration. I've drafted this language for a partnership statute, but the same language would apply for an LLC statute as well. Obviously, feel free to use or edit as you or any other drafting members desire. You may have other issues you want the comment to address. Please let me know if you have any questions or comments.

Comment to Section [405]

The drafting committee and its advisors also considered whether the Act should include default rules for the allocation of profits and losses and default rules for the maintenance of capital accounts. Capital accounts are often maintained by partnerships for a variety of reasons, but the principal purpose for the maintenance of capital accounts is to govern how distributions will be made to partners. Partnerships ordinarily use capital accounts to track each partner's contributions to the partnership, distributions from the partnership, and share of profits and losses, and the partnership will then make interim or liquidating distributions to partners in accordance with their capital account balances. In effect, each partner's capital account serves as a "checking account" where the balance reflects the partner's interest in the partnership and the amount the partner would receive on liquidation of this interest. A partnership agreement may maintain capital accounts for book, tax and regulatory purposes, and the agreement may include numerous provisions defining how capital accounts are maintained for each purpose. For example, for book purposes, some agreements provide for revaluation of assets and the restatement of capital accounts when a partner makes a contribution to the partnership. Adjustments to capital accounts will depend on rules in the agreement for the calculation of profit and loss. For example, profit and loss will depend on depreciation methods adopted by the partnership. It is very unusual to find two partnership agreements with the same set of capital account and profit and loss provisions. Significantly, and this can not be understated, because the principal purpose for allocating profits and losses and maintaining capital accounts is to determine how distributions will be made to partners and the Act already includes default rules describing (i) how, (ii) when and (iii) to whom distributions are made, the drafting committee

concluded there is no reason to add additional default rules governing profit and loss allocations or the maintenance of capital accounts.

Some people outside the drafting committee and advisors argue that capital accounts must be maintained to comply with Federal tax law, however, a partnership that wishes to comply with Federal tax requirements may draft unique and complex provisions that have no application for other entities. In fact, the Federal tax law, which also changes periodically, will dictate how a partnership that uses the default distribution rules in the Act must allocate profit and loss for tax purposes, and these tax consequences would be based on how partners share distributions, even if the Act included default profit and loss allocation and capital account provisions (that may be inconsistent with the distribution provisions).

The drafting committee and advisors also considered drafting default profit and loss and capital account maintenance rules that are consistent with the default distribution provisions in the Act. However, it discovered that almost any set of default rules raises the possibility that the profit and loss allocation and capital account provisions are subject to interpretation that may be inconsistent with the default distribution provisions, thus reducing certainty and increasing litigation risk. It also considered including only a simple allocation rule that profits and losses would be allocated in accordance with how the partners share distributions. That suggestion led to a discussion of what rules are necessary for the calculation of profits and losses, how often allocations should be made or required and the consequences for the failure to "properly" calculate or allocate profits and losses. Since the only reason for this discussion in the first place is to arrive at a default rule for making distributions, the drafting committee concluded addressing these additional issues would not benefit the Act.