FASB Emerging Issues Task Force

Issue No. 07-4

Title: Application of the Two-Class Method under FASB Statement No. 128, *Earnings per Share*, to Master Limited Partnerships

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Previously distributed EITF materials: Issue Summary No. 1, dated May 23, 2007

References:

FASB Statement No. 128, *Earnings per Share* (FAS 128)

Proposed FSP EITF 03-6-a, "Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities" (proposed FSP EITF 03-6-a)

EITF Issue No. 03-6, "Participating Securities and the Two-Class Method under FASB Statement No. 128" (Issue 03-6)

EITF Issue No. 04-8, "The Effect of Contingently Convertible Instruments on Diluted Earnings per Share" (Issue 04-8)

EITF Abstracts, Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share" (Topic D-72)

EITF Abstracts, Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders" (Topic D-82)

AICPA Statement of Position 95-2, "Financial Reporting by Nonpublic Investment Partnerships" (SOP 95-2)

International Accounting Standard 33, *Earnings per Share* (IAS 33)

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. Publicly traded master limited partnerships (MLPs) often issue multiple classes of securities that may participate in partnership distributions according to a formula specified in the partnership agreement. A typical MLP is generally formed by the general partner contributing mature assets with stable cash flows to the partnership in exchange for its general partner interest (the GP Interest) and incentive distribution rights (the IDRs). The MLP then issues publicly-traded common units held by limited partners (the Common Units). Generally, the IDRs are viewed as being a return on the GP's investment whereby the GP has an additional mechanism to participate in the performance of the partnership and represent a separate class of non-voting limited partner interest (LP interest). However, some arrangements are structured such that the IDRs are not a separate LP interest, but are embedded within the GP Interest. When the IDRs are a separate LP interest, then the holder of the IDRs (which is initially the GP) may transfer or sell the IDRs subject to consent requirements of the limited partners (LPs) prior to a specified date. It is the FASB staff's understanding that a sale or transfer of the IDRs has not been frequently observed in practice. When the IDRs are embedded within the GP Interest, the IDRs cannot be detached and transferred. Except for the GP Interest, the IDR holder does not have a separate residual ownership interest in the partnership. This Issue Summary Supplement does not intend to provide guidance on the application of the two-class method when the IDRs are embedded in the GP Interest.

2. MLPs are predominately utilized in the energy industry and more specifically in the pipeline business because of the stable income generated by those businesses. The GP is responsible for conducting, directing, and managing all activities of the MLP. The GP is not compensated for its services as the GP. However, the GP is reimbursed on a monthly basis for all direct and indirect expenses that the GP incurs or payments it makes on behalf of the MLP. Those expenses include, for example, salaries, bonuses, and incentive compensation paid to employees of the GP who perform services for the MLP. Some view the GP's role as being administrative because of the self-sustaining nature of the businesses that MLPs are typically involved in. Others view the GP's role as not being different from what the GP was doing prior to contributing the assets to the MLP.

3. The partnership agreement obligates the GP to distribute 100 percent of the partnership's Available Cash[1] at the end of each quarter to the GP, LPs, and, when certain thresholds are met, the IDR holder via a distribution waterfall (that is, a schedule that prescribes distributions to the GP, LPs, and IDR holder at each threshold). Some partnership agreements further state that the IDR holder is not entitled to distributions other than those provided in the distribution waterfall for Available Cash. After taking into account any priority income allocations to IDR holder(s)[2] and losses previously allocated to the partners, the net income (or loss) of the partnership is allocated to the capital accounts of the GP and LPs based on their ownership percentages. Therefore, due to the differences between Available Cash and net income (or loss), an investor's participation in the partnership's distributions often does not mirror the partnership's allocation of the entity's income or losses to the investor's capital accounts.

4. It is not uncommon for MLPs to encounter substantial timing differences between the distribution of cash and the recognition of income. This may be due to large non-cash charges occurring early in the entity's life (that is, depreciation, depletion, and amortization). Thus, early in their existence, these partnerships often will distribute cash in excess of their reported earnings. In addition, the partnership may operate in a seasonal industry, such that earnings are generated primarily in one quarter, but cash distributions are made over the course of a year. In periods during which earnings are not sufficient to cover distributions to the various partnership interests, the capital accounts of the remaining classes of partnership interests will absorb the deficiency created by the allocation of earnings to the extent of distributions to the IDR holder.

5. FAS 128 requires entities with capital structures that include (a) securities that may participate in dividends with common stocks according to a predetermined formula (for example, two for one) with, at times, an upper limit on the extent of participation (for example, up to, but

[1] Available Cash is typically defined in the partnership agreement as all cash on hand at the end of each quarter less cash retained by the partnership as capital to (i) operate the business (for example, future capital expenditures), (ii) comply with applicable law, debt, and other agreements, and (iii) provide funds for distribution to the Common Unit, GP, and IDR holders for any one or more of the next four quarters.
[2] The priority allocation to the IDR holder(s) is the allocation of net income equal to the amount of the cash distribution to the IDR holder(s) in a given period to such holder's "capital account" (effectively maintaining such account at a zero balance over the life of the partnership).

not beyond, a specified amount per share) or (b) a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights to apply the two-class method of computing earnings per unit. Because of the capital structure of MLPs (that is, the existence of the GP's and LPs' interests), the partnership is required to apply the two-class method. Paragraph 61 of FAS 128 states, in part,

> The two-class method is an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under that method:
>
> a. Income from continuing operations (or net income) shall be reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends (or interest on participating income bonds) that must be paid for the current period (for example, unpaid cumulative dividends).
> b. The remaining earnings shall be allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed. The total earnings allocated to each security shall be determined by adding together the amount allocated for dividends and the amount allocated for a participation feature.
> c. The total earnings allocated to each security shall be divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for the security.
> d. Basic and diluted EPS data shall be presented for each class of common stock. [Footnote reference omitted.]

Previous Task Force Discussions

6. The original issue brought to the Task Force at the June 14, 2007 EITF meeting was as follows:

> When applying the two-class method under FAS 128, whether current period earnings of an MLP should be allocated to holders of IDRs.

7. At its June 14, 2007 meeting, the Task Force discussed this Issue but was not asked to reach any conclusions. Some Task Force members inquired about the nature of the GP's involvement with the MLP and the accounting for the payments to the IDR holder as equity distributions. The additional information regarding the nature of the GP's involvement with the MLP has been

provided in the background section of this Issue Summary. The FASB staff believes that questions regarding the accounting for the payments to the IDR holder as equity distributions or compensation are beyond the scope of this Issue as those questions would be applicable to many other partnership arrangements. The FASB staff notes that a similar question was considered by the Accounting Standards Executive Committee (AcSEC) related to nonpublic investment partnerships in SOP 95-2. Paragraph .22 of SOP 95-2 indicates that the accounting for payments to general partners should conform to the structure of the partnership agreement because AcSEC did not believe that it could issue definitive guidance without deliberation of broader partnership issues. In addition to not providing guidance on the application of the two-class method when the IDRs are embedded in the GP Interest, this Issue Summary Supplement does not intend to provide any guidance on the assessment of whether the distribution to the IDR holder should be classified as compensation or an equity distribution. That determination can be made only after a careful consideration of all of the relevant facts and circumstances.

8. The FASB staff believes that this Issue is relevant irrespective of the accounting treatment for the distribution (that is, expense or equity) because, based on the definition of a participating security in paragraph 60(a) of FAS 128 and the guidance in Issue 2 of Issue 03-6, the IDRs are considered a participating security. That is, because the IDR holder may participate in distributions with the GP and LPs according to the distribution waterfall, the IDRs are a participating security and, therefore, an entity would need to determine how current period earnings of the MLP should be allocated to the IDR holder.

9. The Task Force also requested that the staff provide additional examples illustrating the application of the various alternatives for discussion at the September 11, 2007 EITF meeting. Those additional examples are provided in Exhibit 07-4A. In developing the alternative viewpoints to be included in this Issue Summary Supplement, the FASB staff removed what was originally View A in Issue Summary No. 1 (IDRs are not participating securities and any distributions to the IDR holder should be treated as a preferential distribution) because comments from Task Force members at the June meeting seemed to indicate that the IDRs would always represent a participating security.

Accounting Issues and Alternatives

Issue: When applying the two-class method under FAS 128, how current period earnings of an MLP should be allocated to the IDR holder.

View A: When current period earnings are in excess of cash distributions, undistributed earnings should be allocated to the GP, LPs, and IDR holder as if the undistributed earnings were Available Cash. When cash distributions are in excess of current period earnings, net income (or loss) should be reduced (or increased) by the distribution to the IDR holder to arrive at net income (or loss) available to the GP and LPs. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement (assuming the IDR holder does not have an obligation to share in the losses of the partnership).

10. Proponents of View A believe that when earnings exceed cash distributions for the period, undistributed earnings should be allocated to the IDRs using the distribution waterfall as if the undistributed earnings were Available Cash (by assuming that any additional earnings had been made available for distribution as if they were Available Cash). Proponents of View A acknowledge that this allocation may not reflect the actual distributions over the life of the partnership. However, proponents of View A believe that this allocation of undistributed earnings to the IDR holder is required based on the guidance in paragraph 61(b) of FAS 128, which states that under the two-class method,

> The remaining earnings shall be allocated to the common stock and participating securities to the extent that each security may share in earnings *as if all earnings for the period had been distributed*. [Emphasis added.]

11. Further, proponents of View A believe that when cash distributions are in excess of earnings, net income (or loss) should be reduced (or increased) by the distribution made to the IDR holder similar to a preferential distribution to preferred stockholders. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement. Proponents of View A believe that computing earnings per unit in this manner ensures that

earnings per unit represents an allocation of earnings and not a return of capital or reallocation of capital.

12. Opponents of View A believe that the application of View A is inconsistent with paragraph 61(a) of FAS 128, which requires a reduction of net income by the amount of dividends declared for each class of stock. Opponents of View A acknowledge that paragraph 61(a) of FAS 128 does not specifically address an increase of net losses by the amount of dividends declared. However, opponents of View A note that paragraph A14(a) of IAS 33 does require an increase in net loss by the amount of dividends declared. Paragraph A14(a) of IAS 33 states,

> Profit or loss attributable to ordinary equity holders of the parent entity is adjusted (a profit reduced and a loss increased) by the amount of dividends declared in the period for each class of shares and by the contractual amount of dividends (or interest on participating bonds) that must be paid for the period (for example, unpaid cumulative dividends). [Footnote omitted.]

Therefore, under IFRS, net income (or loss) would be reduced (or increased) by the distributions to the GP, LPs, and IDR holder and the resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement. If a consensus is reached on View A, opponents of View A highlight the fact that as it relates to cash distributions in excess of earnings, the EPS guidance under U.S. GAAP would be divergent from IFRS.

13. Under View A, current period earnings would be allocated as follows:

a. **Earnings in Excess of Cash Distributions**: In addition to cash distributions, undistributed earnings would be allocated to the GP, LPs, and IDR holder using the distribution waterfall as if the undistributed earnings were Available Cash.

b. **Cash Distributions in Excess of Earnings**: Net income (or loss) would be reduced (or increased) by distributions made to the IDR holders. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement.

Exhibit 07-4A provides an illustration of the application of View A in calculating basic earnings per unit.

14. Proponents of View A believe that if an entity determines that distributions to the IDR holder is compensation, then the entity should ensure that it is not double counting the effects of the distribution by including the distribution as both a reduction (or increase) to net income (or loss) (compensation expense) and a reduction (or increase) of net income (or loss) available to the GP and LPs (undistributed earnings). Proponents of View A believe that this is consistent with the preliminary guidance provided in proposed FSP EITF 03-6-a.

View A': Same as View A, except when cash distributions are in excess of earnings, net income (or loss) would be reduced (or increased) by the actual distributions to the GP, LPs, and IDR holder. The resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (assuming the IDR holder does not have an obligation to share in the losses of the partnership).

15. Proponents of View A' note that the two-class method is performed in two steps. The first step in subparagraph 61(a) of FAS 128 reduces net income by the amount of dividends declared for each class of common stock and participating security. Proponents of View A' believe that in the first step in subparagraph 61(a), a net loss would be increased by dividends declared for each class of common stock and participating security. Proponents of View A' believe that this allocation should be made despite distributions exceeding earnings. The second step is to allocate the remaining earnings (or, in this scenario, losses) to common stock and participating securities. Because the IDR holder is not typically obligated to share in the losses of the partnership, the losses would be allocated to the GP and LPs based on their respective sharing of losses. Proponents of View A' note that View A' is consistent with IAS 33. Opponents of View A' note that paragraph 61 of FAS 128 states that the two-class method is an earnings allocation formula. Opponents of View A' believe that performing the computation of earnings per unit in the manner supported by proponents of View A' would result in the two-class method representing either a return of capital or a reallocation of capital, which would be contrary to the stated purpose of earnings per share. Proponents of View A' note that the amount of cash

distributions in excess of earnings that would be allocated to the GP and LPs under this view reduces the allocation of actual distributions to the GP and LPs. Therefore, proponents of View A' believe that the resulting earnings per unit would not represent a return of capital or reallocation of capital.

16. In summary, under View A', current period earnings would be allocated as follows:

   a. **Earnings in Excess of Cash Distributions**: In addition to cash distributions, undistributed earnings would be allocated to the GP, LPs, and IDR holder using the distribution waterfall as if the undistributed earnings were Available Cash. This allocation is the same as View A.
   b. **Cash Distributions in Excess of Earnings**: Net income (or loss) would be reduced by (or increased by) the actual cash distributions to the GP, LPs, and IDR holder. Unless the IDR holder has an obligation to share in the losses of the partnership (as described in paragraphs 17 and 18 of Issue 03-6), the resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement.

Exhibit 07-4A provides an illustration of the application of View B in calculating basic earnings per unit.

View B: When current period earnings are in excess of cash distributions, the allocation of undistributed earnings should be based on the terms of the partnership agreement. When cash distributions are in excess of current period earnings, net income (or loss) should be reduced (or increased) by the distribution to the IDR holder to arrive at net income (or loss) available to the GP and LPs. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement (assuming the IDR holder does not have an obligation to share in the losses of the partnership).

17. When earnings exceed cash distributions, proponents of View B believe that undistributed earnings should be allocated to the GP, LPs, and IDR holder in accordance with the terms of the partnership agreement and not as if undistributed earnings were Available Cash (by assuming that any additional earnings had been made available for distribution as if they were Available Cash). Proponents of View B highlight the fact that some partnership agreements explicitly limit distributions to the IDR holder to the distribution waterfall for Available Cash, as that term is defined in the partnership agreement. While a similar limitation may exist in these agreements for the GP and LPs, proponents of View B believe that because the GP and LPs have a residual ownership interest in the partnership, any additional amounts made available for distribution (that is, undistributed earnings) should be allocated to the GP and LPs based on their ownership percentages. Therefore, when the partnership agreement explicitly limits distributions to the IDR holder as described above, proponents of View B do not believe that undistributed earnings should be allocated to the IDR holder because their contractual participation right is capped according to a formula based on Available Cash, as defined, and that amount has already been distributed to the IDR holder. Proponents of View B believe that their view is consistent with the consensus reached in Issue 3 of Issue 03-6, which states,

> …undistributed earnings for a period should be allocated to a participating security based on the *contractual participation rights of the security* to share in those current earnings as if all of the earnings for the period had been distributed. [Emphasis added.]

18. Proponents of View B believe that if the partnership agreement does not explicitly limit the distributions to the IDR holder, then undistributed earnings should be allocated to the IDR holder as if all earnings were distributed as Available Cash. Therefore, undistributed earnings would be allocated to the GP, LPs, and IDR holder using the distribution waterfall as if the undistributed earnings were Available Cash (by assuming that any additional earnings had been made available for distribution as if they were Available Cash). Proponents of View B note that their view on the allocation of undistributed earnings when the partnership agreement does not limit distributions to the IDR holder is the same as View A.

19. When cash distributions are in excess of earnings, proponents of View B would allocate current period earnings in the manner described in paragraphs 10 and 11 of this Issue Summary Supplement (View A).

20. Under View B when the terms of the partnership agreement limit the distributions to the IDR holder, current period earnings would be allocated as follows:

a. **Earnings in Excess of Cash Distributions**: Other than cash distributions, no undistributed earnings would be allocated to the IDR holder and undistributed earnings would be allocated to the GP and LPs based on their respective sharing of net income specified in the partnership agreement.

b. **Cash Distributions in Excess of Earnings**: Net income (or loss) would be reduced (or increased) by distributions made to the IDR holder. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement. This allocation is the same as View A.

Exhibit 07-4A provides an illustration of the application of View B in calculating basic earnings per unit when the terms of the partnership agreement limit the distributions to the IDR holder. Proponents of View B note that the resulting earning per unit under View B will be the same as View A except when earnings are in excess of cash distributions. If the terms of the partnership do not limit distributions to the IDR holder, then the allocation of current period earnings would be the same as that described under View A.

21. Proponents of View B believe that if an entity determines that distributions to the IDR holder is compensation, then the entity should ensure that it is not double counting the effects of the distribution by including the distribution as both a reduction (or increase) to net income (or loss) (compensation expense) and a reduction (or increase) of net income (or loss) available to the GP and LPs (undistributed earnings). Proponents of View B believe that this is consistent with the preliminary guidance provided in proposed FSP EITF 03-6-a.

View B': Same as View B, except when cash distributions are in excess of earnings, net income (or loss) would be reduced (or increased) by the actual distributions to the GP, LPs, and IDR holder. The resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement (assuming the IDR holder does not have an obligation to share in the losses of the partnership).

22. View B' is the same as View A', except that it follows the principle set forth in View B when earnings exceed cash distributions. Therefore, when cash distributions are in excess of earnings, proponents of View B' would allocate current period earnings in the manner described in paragraph 14 of this Issue Summary Supplement (View A').

23. Under View B', current period earnings would be allocated as follows:

a. **Earnings in Excess of Cash Distributions**: Other than cash distributions, no undistributed earnings would be allocated to the IDR holder and undistributed earnings would be allocated to the GP and LPs based on their respective sharing of net income specified in the partnership agreement. This allocation is the same as View B.

b. **Cash Distributions in Excess of Earnings**: Net income (or loss) would be reduced by (or increased by) the actual cash distributions to the GP, LPs, and IDR holder. Unless the IDR holder has an obligation to share in the losses of the partnership (as described in paragraphs 17 and 18 of Issue 03-6), the resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement. This allocation is the same as View A'.

Exhibit 07-4A provides an illustration of the application of View B' in calculating basic earnings per unit.

Transition and Effective Date

24. The staff recommends that the consensus on this Issue be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. Earlier application is not permitted. The staff recommends that the guidance in this Issue

be applied retrospectively for all financial statements presented. The staff is recommending retrospective application for comparative purposes because it would be consistent with the application of previous consensuses and other accounting standards that have affected the computation and presentation of earnings per share information (such as, Topics D-72 and D-82, and Issues 03-6 and 04-8).

Exhibit 07-4A

APPLICATION OF THE ALTERNATIVE VIEWS

The following example illustrates the application of the alternative views set forth in this Issue Summary. Exhibit 07-4B summarizes earnings per unit for each of the alternative views illustrated in this example.

> Partnership ABC has 9,800 Common Units outstanding held by the LPs and 200 GP units outstanding held by the GP during the first, second, and third quarters of 20X7. The allocation of net income to the capital accounts of the GP and LPs is based on their ownership percentages (98 percent and 2 percent, respectively) after giving effect to any priority income allocations to the IDR holder(s).
>
> The GP also holds IDRs, which are a non-voting limited partnership interests that entitle the holder to cash distributions when certain thresholds are achieved. The GP is obligated to distribute 100 percent of the partnership's Available Cash at the end of each quarter based on a distribution waterfall specified in the partnership agreement. At the end of the first, second, and third quarters of 20X7, the partnership had Available Cash of $20,000 each quarter (fully distributed to the GP, LPs, and IDR holder) and net income (loss)[3] of $50,000, $ 15,000 and $(10,000), respectively. The following table illustrates the cumulative amount of Available Cash that would be distributed to the Common Units, GP Interest, and IDRs at each of the thresholds based on the distribution waterfall in Partnership ABC's partnership agreement:

		Waterfall Percentage			**Cumulative** Distribution by Interest			
	Distribution per Common Units (LPs)	LPs	GP	IDRs	LPs[4]	GP[5]	IDRs	Total
1st Threshold	$ 0.40	98%	2%	0%	$ 3,920.00	$ 80.00	$ -	$ 4,000.00
2nd Threshold	$ 0.50	85%	2%	13%	$ 4,900.00	$ 103.06	$ 149.88[6]	$ 5,152.94
3rd Threshold	$ 0.60	75%	2%	23%	$ 5,880.00	$ 129.19	$ 450.42[7]	$ 6,459.61
Thereafter	N/A	50%	2%	48%				

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[3] Net income (or loss) assumes that IDR distribution is not accounted for as compensation expense.

[4] Cumulative distribution to the LPs equals the distribution per common unit at each threshold multiplied by 9,800 common units.

[5] Cumulative distribution to the GP equals 2 percent of the total cumulative distribution at each threshold.

[6] [$5,152.94 (total cumulative distribution at 2nd threshold) − $ 4,000 (total distribution at 1st threshold)] multiplied by 13% waterfall percentage.

[7] $149.88 (distribution to IDRs at 2nd threshold) plus [($6,459.61 (total cumulative distribution at 3rd threshold) − $5,152.94 (total cumulative distribution at 2nd threshold)) multiplied by 23% waterfall percentage].

Application of the Two-Class Method under View A

<u>First Quarter 20X7 – Earnings in Excess of Cash Distributions</u>

Net Income		$50,000
Less distributions paid:		
Incentive Distribution Rights	$ 6,949.80[8]	
General Partner	400.00[9]	
Limited Partners	12,650.20[10]	
		20,000
Undistributed Q1 20X7 earnings		$30,000

Allocation of undistributed earnings:

To incentive distribution rights:
48% cash waterfall percentage × $30,000 = $14,400[11]

To general partner:
2% cash waterfall percentage × $30,000 = $600
$600 ÷ 200 units = $3.00 per unit

To limited partners:
50% cash waterfall percentage × $30,000 = $15,000
$15,000 ÷ 9,800 units = $1.53 per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$1.29
Undistributed earnings	3.00	1.53
Total	$5.00	$2.82

8 $450.42 cumulative distribution to IDR holders for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 48% waterfall percentage].
9 $129.19 cumulative distribution to GP for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 2% waterfall percentage].
10 $5,880 cumulative distribution to LPs for 3rd threshold plus [($20,000 (Available Cash) − $6,459.61 (total cumulative distribution for 3rd threshold)) multiplied by 50% waterfall percentage].
11 IDR holders do not have an ownership interest in the partnership. Therefore, undistributed earnings per unit cannot be calculated.

Second Quarter 20X7 – Cash Distributions in Excess of Earnings

Net Income	$15,000.00
Less: Distribution to IDR holder	6,949.80
Net Income Available to the GP and LPs	$ 8,050.20

Allocation of Net Income to the GP and LPs:[12]

To general partner:
2% ownership interest × $8,050.20 = $161
$161 ÷ 200 units = $.81

To limited partners:
98% ownership interest × $8,050.20 = $7,889.20
$7,889.20 ÷ 9,800 units = $.81

Basic EPU amounts:

General Partner	$.81
Limited Partners	$.81

Third Quarter 20X7 – Net Loss

Net Loss	$(10,000.00)
Less: Distribution to IDR holder	6,949.80
Net Loss Available to GP and LPs	$(16,949.80)

Allocation of Net Loss to GP and LPs:[13]

To general partner:
2% ownership interest × $(16,949.80) = $(339)
$(339) ÷ 200 units = $(1.70) per unit

To limited partners:
98% ownership interest × $(16,949.80) = $(16,610.80)
$(16,610.80) ÷ 9,800 units = $(1.70) per unit

[12] Because cash distributions to the GP and LPs are in excess of the remaining earnings, net income available to the GP and LPs would be allocated based on their respective ownership percentages to ensure that earnings per unit does not include a return of capital to the GP and LPs.
[13] Assumes that IDR holders do not have the contractual obligation to share in the losses of the MLP. Further, net loss is allocated to the GP and LPs to ensure that the earnings per unit does not represent a return of capital to the GP and LPs.

Basic EPU amounts:

General Partner	$(1.70)
Limited Partners	$(1.70)

Application of the Two-Class Method under View A'

First Quarter 20X7 – Earnings in Excess of Cash Distributions

Earnings per unit when earnings exceed cash distributions would be computed in the same manner as that illustrated in View A.

Second Quarter 20X7 – Cash Distributions in Excess of Earnings

Net Income		$15,000
Less distributions paid:		
Incentive Distribution Rights	$ 6,949.80	
General Partner	400.00	
Limited Partners	12,650.20	
		20,000
Undistributed Q2 20X7 earnings		$(5,000)

Allocation of Net Loss to GP and LPs:[14]

To general partner:
2% ownership interest × $(5,000) = $(100)
$(100) ÷ 200 units = $(.50) per unit

To limited partners:
98% ownership interest × $(5,000) = $(4,900)
$(4,900) ÷ 9,800 units = $(.50) per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$ 1.29
Undistributed earnings	(.50)	(.50)
Total	$1.50	$ .79

[14] Assumes that IDR holders do not have the contractual obligation to share in the losses of the MLP.

<u>Third Quarter 20X7 – Net Loss</u>

Net Loss		$(10,000)
Less distributions paid:		
Incentive Distribution Rights	$ 6,949.80	
General Partner	400.00	
Limited Partners	12,650.20	
		20,000
Undistributed Q3 20X7 earnings		$(30,000)

Allocation of Net Loss to GP and LPs:[15]

To general partner:
2% ownership interest × $(30,000) = $(600)
$(600) ÷ 200 units = $(3.00) per unit

To limited partners:
98% ownership interest × $(30,000) = $(29,400)
$(29,400) ÷ 9,800 units = $(3.00) per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	$2.00	$ 1.29
Undistributed earnings	(3.00)	(3.00)
Total	$(1.00)	$(1.71)

Application of the Two-Class Method under View B Assuming Contract Limits Distribution to IDR Holder

<u>First Quarter 20X7 – Earnings in Excess of Cash Distributions</u>

Net Income		$50,000
Less distributions paid:		
Incentive Distribution Rights	$ 6,949.80	
General Partner	400.00	
Limited Partners	12,650.20	
		20,000
Undistributed Q1 20X7 earnings		$30,000

Allocation of undistributed earnings:

To incentive distribution rights:
0% ownership interest × $30,000 = $0

[15] Assumes that IDR holders do not have the contractual obligation to share in the losses of the MLP.

To general partner:
2% ownership interest × \$30,000 = \$600
\$600 ÷ 200 units = \$3.00 per unit

To limited partners:
98% ownership interest × \$30,000 = \$29,400
\$29,400 ÷ 9,800 units = \$3.00 per unit

Basic EPU amounts:

	General Partner	Limited Partners
Distributed earnings	\$2.00	\$1.29
Undistributed earnings	3.00	3.00
Total	\$5.00	\$4.29

Second Quarter 20X7 – Cash Distributions in Excess of Earnings

Earnings per unit when cash distributions exceed earnings would be computed in the same manner as that illustrated in View A.

Third Quarter 20X7 – Net Loss

Earnings per unit in periods of net losses (that is, when cash distributions exceed earnings) would be computed in the same manner as that illustrated in View A.

Application of the Two-Class Method under View B' Assuming Contract Limits Distribution to IDR Holder

First Quarter 20X7 – Earnings in Excess of Cash Distributions

Earnings per unit when earnings exceed cash distributions would be computed in the same manner as that illustrated in View B.

Second Quarter 20X7 – Cash Distributions in Excess of Earnings

Earnings per unit when cash distributions exceed earnings would be computed in the same manner as that illustrated in View A'.

Third Quarter 20X7 – Net Loss

Earnings per unit in periods of net losses (that is, when cash distributions exceed earnings) would be computed in the same manner as that illustrated in View A'.

Exhibit 07-4B

SUMMARY OF ALTERNATIVE VIEWS AND BASIC EPU FOR GP AND LPs

<table>
<tr><th></th><th colspan="2">View A</th><th colspan="2">View A'</th></tr>
<tr><th></th><th></th><th>EPU</th><th></th><th>EPU</th></tr>
<tr><td>Earnings in excess of distributions (1st quarter)</td><td>In addition to cash distributions, undistributed earnings would be allocated to the GP, LPs, and IDR holder using the distribution waterfall as if the undistributed earnings were Available Cash.</td><td>$5.00 (GP)
$2.82 (LPs)</td><td>In addition to cash distributions, undistributed earnings would be allocated to the GP, LPs, and IDR holder using the distribution waterfall as if the undistributed earnings were Available Cash.</td><td>$5.00 (GP
$2.82 (LPs)</td></tr>
<tr><td>Distributions in excess of earnings (2nd quarter)</td><td rowspan="2">Net income (or loss) would be reduced (or increased) by distributions made to the IDR holders. The resulting net income (or loss) available to the GP and LPs would be allocated to the GP and LPs based on their respective sharing of net income or net loss specified in the partnership agreement.</td><td>$.81 (GP)
$.81 (LPs)</td><td rowspan="2">Net income (or loss) would be reduced by (or increased by) the actual cash distributions to the GP, LPs, and IDR holder. Unless the IDR holder has an obligation to share in the losses of the partnership (as described in paragraphs 17 and 18 of Issue 03-6), the resulting net loss would be allocated to the GP and LPs based on their respective sharing of losses specified in the partnership agreement.</td><td>$1.50 (GP)
$ .79 (LPs)</td></tr>
<tr><td>Net loss (3rd quarter)</td><td>$(1.70) (GP)
$(1.70) (LPs)</td><td>$(1.00) (GP)
$(1.71) (LPs)</td></tr>
</table>

<table>
<tr><th></th><th colspan="2">View B</th><th colspan="2">View B'</th></tr>
<tr><th></th><th></th><th>EPU</th><th></th><th>EPU</th></tr>
<tr><td>Earnings in excess of distributions (1st quarter)</td><td>Other than cash distributions, no undistributed earnings would be allocated to the IDR holder and undistributed earnings would be allocated to the GP and LPs based on their respective sharing of net income specified in the partnership agreement.</td><td>$5.00 (GP)
$4.29 (LPs)</td><td>Other than cash distributions, no undistributed earnings would be allocated to the IDR holder and undistributed earnings would be allocated to the GP and LPs based on their respective sharing of net income specified in the partnership agreement.</td><td>$5.00 (GP)
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$(1.71) (LPs)</td></tr>
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