TAX CONSIDERATIONS WITH MULTI-MEMBER LLCs

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The Nevada Limited Liability Company Act (Nevada Revised Statutes, Chapter 86) was first adopted in 1991, and provides owners (referred to as members) with great flexibility, including flexibility in the way they structure their economic deals with each other. But, with flexibility comes complexity, especially for limited liability companies (LLCs) with more than one member.

Since the final check-the-box regulations became effective in 1997, by default, LLCs with more than one member are considered partnerships for federal tax purposes. As tax partnerships, multi-member LLCs are taxed under one of the most complicated subchapters in the entire Internal Revenue Code: Subchapter K. Indeed, in *Foxman v. Commissioner*, 41 T.C. 535 (1964), the United States Tax Court stated:

> *The distressingly complex and confusing nature of the provisions of subchapter K presents a formidable obstacle to the comprehension of these provisions without the expenditure of a disproportionate amount of time and effort even by one who is sophisticated in tax matters with many years of experience in the tax field. Its most complex provisions may confidently be dealt with by at most only a comparatively small number of specialists who have been initiated into its mysteries.*

Practitioners, therefore, should be careful when drafting the main governing document for an LLC – the Operating Agreement – to ensure compliance with Subchapter K, and should also take caution when using Operating Agreement forms containing boilerplate tax and other language.

Below are some of the tax issues to consider when working with multi-member LLCs:

The Distinction Between Allocations and Distributions

An LLC Operating Agreement should provide for, both:

1. The manner in which profits and losses are allocated to the members, and
2. The manner in which net cash (if any is available) is distributed to the members.

Allocations and distributions are two very different concepts. A member pays taxes or deducts losses based on the allocation of profits or losses the member receives. Alternatively, an LLC's distribution provision (often called the distribution waterfall) determines the manner in which the members share the net cash distributed by the LLC, which is the basis of the members' economic deal with each other.

Therefore, an LLC Operating Agreement should contemplate both allocations and distributions. In some cases, the manner in which each is divided between members during a particular year differs, and in other cases (such as targeted allocations), allocations are based entirely on the distribution waterfall.

Targeted Allocations

A significant trend in LLCs over the past ten years is the use of targeted allocations (of net profits and losses) instead of the safe harbor allocations that were popular in the past.

With safe harbor allocations, in order to satisfy the "substantial economic effect" safe harbor in Subchapter K:

1. Capital accounts must be maintained in accordance with IRC Section 704(b),
2. Liquidating distributions must be made in accordance with positive capital accounts, and
3. A "qualified income offset" provision is generally included.

With safe harbor allocations, it is often necessary to model a number of hypothetical scenarios to ensure that the parties' economic deal is maintained when drafting the allocation provisions.

With targeted allocations, however, the members negotiate their economic deal, which is then reflected in the distribution waterfall. Once the economic deal is negotiated, the partnership's allocation provisions are drafted in a way that forces the allocations of profit or loss to track the economic deal by reference to the distribution waterfall. Generally, with targeted allocations (and in contrast to safe harbor allocations), liquidating distributions are not made in accordance with positive capital accounts.

Targeted allocations have a number of benefits. First, targeted allocations are generally more easily understood by LLC members. The members know and understand their economic deal, but often have difficulty understanding the Operating Agreement provisions required in connection with safe harbor allocations. Also, with safe harbor allocations, mistakes can be made in drafting the allocation provisions in the Operating Agreement that can affect or distort the economic deal the members have negotiated. By forcing allocations to be made in accordance with the distribution waterfall, and therefore the economic deal the members negotiated, the attorney ensures the preservation of the economic deal. The burden of making sure the allocations work properly falls on the tax preparer (or accountant), not the attorney, and modeling of various scenarios is not necessary. This makes sense, as the accountant is generally the one maintaining the capital accounts and making year-end adjustments.

Equity-Based Compensation using "Profits Interests"

LLCs often want to incentivize and reward key employees and service providers through equity-based compensation. Although stock options are often used with corporations, options are not a tax-favorable way to grant equity-based compensation in tax partnerships and are rarely used. LLCs, however, can issue equity-based compensation in a tax favorable manner by granting "profits interests."

The Internal Revenue Service (IRS) has announced that it will not treat the receipt of profits interests by a service provider as a taxable event to either the partner or the partnership, if the profits interests are received in exchange for providing services to, or for the benefit of, the partnership in a partner capacity, or in anticipation of being a partner. Further, because the IRS measures the value of a partnership interest received for services at its liquidation value (i.e., the amount the service provider would receive if the LLC were to liquidate and sell its assets) determined at the time of receipt, even if the interests are subject to vesting, a service provider is not taxable in the future as the profits interests vest.

It is important to ensure that the grant of profits interests qualifies as such under applicable IRS guidance, since the grant of a capital interest (as opposed to a profits interest) by an LLC in return for services is generally fully taxable to the recipient as ordinary income at the time of grant. Also, by definition, a profits interest means that the recipient shares only in future profits and appreciation and does not share in the current value of the LLC's assets. For example, assume that an LLC's founding members, A and B, each contribute $50,000 to the LLC. If the LLC grants a 20 percent profits interest to C in return for services (and the other requirements are satisfied), and liquidates the next day, C receives $0. If C receives a 20 percent capital interest in the LLC, however, C would receive $20,000 upon liquidation (reducing the amount received by both A and B). This is the concept of liquidation value. Thus, if C receives profits interests, the LLC may want to provide for "catch-up allocations" over time, or possibly immediately prior to a liquidity event, in its Operating Agreement, so that C truly receives 20 percent of the value of the LLC's assets upon liquidation.

Technical Terminations

Any time there is a transfer of 50 percent or more of the total interests in partnership capital and profits, Subchapter K provides that the tax partnership terminates for tax purposes (also called a technical termination). In such a situation, the IRC provides that the assets of the existing tax partnership are contributed to a "new" tax partnership, and the "old" partnership is liquidated for tax purposes, distributing the new partnership units to its members. Because of these deemed steps, a technical termination can result in unexpected tax consequences, including the restart of cost recovery periods for depreciable assets (resulting in lower depreciation deductions each year). Therefore, practitioners may want to consider including provisions in the LLC Operating Agreement that address technical terminations. Also, it is worth noting these rules when structuring a transaction – in some cases, for example, a technical termination can be avoided by restructuring the transaction as a redemption. NL

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