Alberty.com - Spring 2003 Newsletter

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Special Allocations

When partnerships were the most common form of unincorporated business entity, special allocations were rare. Even if a partnership did make a special allocation, some fairly short and simple additions to the partnership agreement were all that was needed to insure that it was effective for tax purposes.

But things have changed. It's quite common for an LLC to make a special allocation, and the additional provisions that must go into an LLC's operating agreement to insure its effectiveness are anything but short and simple.

A partnership or LLC is not a taxpaying entity. The income, loss, and other tax items of the entity must be allocated between its owners, be they partners or members, and reported on the owners' individual income tax returns. A special allocation occurs if any income, loss, or other tax item is allocated in a way that neither has substantial economic effect nor is in accordance with the owners' interests in the entity. A special allocation is ineffective for tax purposes under section 704(b) of the Internal Revenue Code, and the affected items can be reallocated by the IRS. A reallocation, which may well inconsistent with the owners' expectations and tax planning, can, however, be avoided if the special allocation is deemed to have substantial economic effect, or is deemed to be in accordance with owners' interests, under rules set forth in the income tax regulations.

Whether a partnership has made a special allocation, and if so, whether it's effective for tax purposes, is ordinarily determined under the substantial economic effect test. An allocation has substantial economic effect if the economic consequences of the allocation follow its tax consequences. For example, an allocation of one-half of the losses of a general partnership to one of two partners has substantial economic effect because the losses will reduce the amount of partnership assets available for distribution to the partner when the partnership is dissolved and wound up. If losses are funded by the partnership's borrowing money or acquiring assets on credit, the partner will be personally liable for the partnership's purchase money obligation and will have to pay the obligation if the partnership's assets are inadequate.

If the partner is a limited partner and has no personal liability for partnership obligations, an allocation of losses to the partner is deemed to have substantial economic effect under the income tax regulations so long as the partnership agreement requires capital accounts to be maintained and contains a qualified income offset. Such a provision prevents losses in excess of a limited partner's capital account from being allocated to the partner. Any excess losses are allocated to the general partner, who does not have limited liability and will, therefore, bear the economic consequences if losses that exceed the partners' capital accounts.

It gets a bit more tricky with LLCs because all members have limited liability. An LLC can incur tax losses that are funded by loans to the LLC, or by credit advanced to the LLC, for which no member has personal liability. As a result, a special allocation made by an LLC almost always lacks substantial economic effect. Such an allocation has substantial economic effect only if the LLC's operating agreement requires capital accounts to be maintained and requires members to contribute additional capital to make up deficit balances in their capital accounts when their interests are liquidated. Such provisions are rarely included in LLC operating agreements because of the risk they can be enforced by the LLC's creditors, thus eliminating the members' limited liability protections.

What this means is no allocation made by an LLC is effective for tax purposes unless it's either in accordance with the members' interests in the LLC within the meaning of section 704(b) of the Code or is deemed to be in accordance with the members' interests under the income tax regulations.

An allocation is in accordance with the members' interests in an LLC if it's straight-up. A straight-up allocation occurs if each member of an LLC contributes capital and each member's percentage interest in income, losses, and interim distributions is the same as the percentage of the LLC's capital contributed by the member.

Any deviation from a straight-up allocation results in a special allocation. For example, if one member of an LLC contributes capital, another contributes the services necessary to operate the LLC's business, and they agree to split income and losses equally, the allocation of income and losses is a special allocation because it's not proportionate to the members' capital interests. An equal division of income and losses also can result in a special allocation if both members contribute equal amounts of capital, but a disproportionately large share of the LLC's excess cash is later distributed to one member.

If an LLC makes a special allocation, it will be deemed to be in accordance with the members' interests, and will be effective for tax purposes, only if the following three requirements set forth in section 1.704-2(e) of the income tax regulations are met:

- The LLC's operating agreement requires capital accounts to be maintained;
- The LLC's operating agreement contains a qualified income offset; and
- The LLC's operating agreement contains a minimum gain chargeback.

The first two requirements are straightforward and are familiar because such provisions were routinely included in limited partnership agreements. It's the third requirement that creates problems because it necessitates adding several pages of complex provisions to the operating agreement.

A minimum gain chargeback deals with the possibility that an LLC will realize phantom gain for tax purposes if an asset is purchased with the proceeds of a loan or on credit and the LLC defaults on the purchase money obligation at a time when its tax basis in the asset is less than the outstanding balance of the obligation. Phantom gain is realized when the creditor forecloses on

the asset or accepts a transfer of the asset in lieu of foreclosure because the LLC is treated as having sold the asset for an amount equal to the remaining balance of the purchase obligation. A minimum gain chargeback allocates the phantom gain to the members of the LLC who received the benefit of the depreciation deductions or other tax benefits associated with the asset.

A minimum gain chargeback is lengthy and complex because the income tax regulations attempt to anticipate a variety of situations in which the amount of phantom gain can change or the members' shares of the gain can change. The complexity of a minimum gain chargeback is guaranteed to elicit feelings of utter despair on the first reading, but including such a provision in an LLC's operating agreement is the price one must pay to insure that any special allocation made by the LLC is effective for tax purposes.

New Books

Two new books have been published recently that are of interest to lawyers who work with LLCs.

The first book was written by Steve Alberty, the lawyer who drafts our forms. His book, Limited Liability Companies: A Planning and Drafting Guide, has been published by ALI-ABA and is the type of concise practice guide focusing on real world issues for which ALI-ABA is famous. The book deals with the substantive law, tax, and financial issues arising in the organization, operation, and dissolution of LLCs, as well as the transfer of members' interests in LLCs. The book provides far more information about the issues encountered in drafting LLC documents than can be included in the commentary to our forms, and it can be a valuable resource for a lawyer using our forms. The book is available for purchase at http://www.ali-aba.org/aliaba/BK22.htm.

The second book is Hereof, Thereof and Everywhereof: A Contrarian Guide to Legal Drafting. This readable and entertaining book was written by Harold Darmstadter, a transactions lawyer and columnist for Business Law Today. While the book does not deal with LLCs as such, it does contain a wealth of suggestions for modernizing legal documents and addresses a number of problem areas that arise in drafting LLC documents such as defined terms, boilerplate provisions, and use of examples. If you feel as strongly as we do about trying to draft documents your clients can understand, you'll want to not only read this book but also have it available for future reference. Hereof, Thereof and Everywhereof: A Contrarian Guide to Legal Drafting can be purchased at the publications section of the American Bar Association's Web site, http://www.abanet.org.

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Alberty Publishing LLC
Online Forms for the Legal Profession
P.O. Box 11504 - Eugene, OR 97440
(888) 930-7007 - fax (541) 302-3023

www.alberty.com