State Law & State Taxation Corner

By Thomas E. Rutledge

Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part II)

Part I of this article[1] explored how the default provisions for the allocation of economic and voting rights as set forth in the various LLC Acts are either insufficient or ineffective in common fact situations; to that extent, the acts are themselves deficient. Part II endeavors to apply those same state law rules to those applicable to the capital account rules of the Internal Revenue Code (the "Code"). From that perspective, it becomes even more apparent that the default rules of the various LLC Acts fail to provide workable rules for any but the most simple and most static LLCs.

Why Capital Accounts?

Everything discussed in Part I of this article dealt with the state law issues involved in the creation, operation and ultimate liquidation of an LLC; intentionally excluded from that discussion were issues dealing with taxation. One of the great advantages of the LLC form is its ability, assuming it has two or more members, to be classified under the Code as a "partnership," taxed under Subchapter K of the Code.[2]

Taxation under Subchapter K is often viewed as advantageous, although whether it actually is in a particular venture is a particularly complicated calculation.[3] In many situations, the imposition of the tax liability upon the activities of the LLC at the member level results in an overall net reduction in total taxes paid *vis-à-vis* the taxes that would be paid under the Subchapter C tax regimen. Another advantage that exists under Subchapter K is the ability, within certain limitations, to make "special allocations" of the tax items of income, gain, loss, depreciation and

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credit. By way of a most crude example, it could be provided that, between the two members of an LLC, one will be paid back the entirety of their investment in the LLC before any amounts are distributed to the second member; after that initial series of payments is made, all allocations and distributions will be to pay back the second member in full; and thereafter they will share equally. Essentially, if at any time you are not allocating all of the tax items *pro-rata* to all of the LLC's members in accordance with their percentage membership interest in the LLC, you have "special allocations."

Which leads us to the climax of our story. Under the Code and specifically the regulations under Code Sec. 704, allocations must have "substantial economic effect" or they may be ignored by the IRS and reallocated among the members based on the IRS's determination of the members' respective interests in the LLC. There are, very broadly speaking, two mechanisms by which special allocations will be deemed to have substantial economic effect:[4]

Unlike basis, which can never be reduced below zero, it is possible for a capital account to go below zero. Assume an LLC of two members, Bob and Scott. Each contributes $100 to the LLC on the day of its formation. The LLC's total capitalization is $200. The next day the LLC is able to borrow, on a nonrecourse basis, $400.[6] The LLC then distributes to each member $200. Neither Scott's nor Bob's capital account is increased by the LLC's indebtedness.[7] The first $100 of the distribution to each member reduces his capital account to zero, and the second $100 distributed to each member reduces his capital account to negative $100.

With an unconditional negative capital account makeup obligation in the Basic Test, assume that the LLC liquidates immediately after making the $200 distribution to each member at a time when each has a negative $100 capital account. Under an unconditional DRO, each member must contribute $100 to the LLC, thereby increasing his capital account to $0. One of the hallmarks of the LLC being, however, limited liability,[8] a DRO is viewed as antithetical to the LLC's purposes and intent.

For that reason, LLC operating agreements typically utilize the Alternate Test and the QIO. With the Alternate Test, the LLC is (i) precluded from making allocations of losses to a member that have the effect of reducing the member's capital account below zero and (ii) required to allocate gross income and gain to a member so as to eliminate as quickly as possible any negative capital account that is created due to an unexpected allocation or distribution (this gross income allocation is the "QIO" provision). Now, there is a good deal more that is required to ensure that your allocations have substantial economic effect, but the QIO is a fundamental provision that must be included in a limited liability company operating agreement that almost certainly does not contain an unconditional DRO, in order for the special allocations to the LLC members to be respected for federal income tax purposes.[9] Furthermore, it often is utilized in even those LLCs without special allocations in order to protect against the creation of negative capital accounts.[10]

Mixing Apples and Oranges–Allocations in Proportion to "Capital Accounts"

It is not an uncommon occurrence to read an operating agreement, which provides that allocations/distributions, either initially or after a special allocation, and voting rights shall be "in proportion to the members' respective positive capital accounts." A provision of this nature is fraught with ambiguity in that it assumes the parties to the operating agreement fully appreciate the rules employed in calculating capital accounts. That assumption is unwarranted.

Staying with our hypothetical LLC from Part I of this article, on day one the capital accounts are Cristin $50, Laura $5 and Heather $0. Laura does not receive any credit in her capital account for her commitment to provide cash capital in the future.[11] "Fine," she responds, "Just borrow the $50 from Friendly National Bank—I'll personally guarantee the entire amount." Well, that might be fine from the perspective of the LLC, but it does nothing to address the calculation of her capital account. Laura may be thinking that her capital account will be credited with the amount of her guarantee of company indebtedness. That is not, however, the case.[12] At the same time, while Heather may receive credit to her capital account for her services as performed, she will have to recognize compensatory income in the amount of the fair market value of the membership interests she receives in consideration thereof.[13] Ultimately, while she will receive an interest in the LLC's total capital, she will as well bear phantom income in an equal amount.

Moving from our simple LLC, any number of issues may arise when, for example, allocating voting rights in proportion to capital accounts. Let us assume that by the end of our first year of operations Laura has paid into the LLC her $50, and it is agreed that Heather has fully performed on her obligation to provide services; each has a capital account of $50 for total capital of $150. Over the next year, the company loses $200.[14] At the end of the year, losses of $50 will be allocated to each member, thereby reducing the capital accounts of Cristin, Laura and Heather to $0.00; the last $50 of losses likely will have been funded by nonrecourse debt (*i.e.*, accounts payable) causing the capital accounts to become negative. And now the time comes for a vote of the members; in what proportion do they vote? No member has a positive capital account and the written operating agreement says the members vote in proportion to positive capital accounts. While ridiculous, the agreement of the members is, *inter alia*, that none of them have voting rights.

Consider another LLC in which Charlsey contributes 10-year property with a fair market value of $100 and in which Micah contributes cash of $100. On the date of organization, each has a capital account of $100. The operating agreement provides for *pro rata* allocation of all tax items, except that all depreciation deductions with respect to the property contributed by Charlsey are to be allocated to Charlsey.[15] At the end of the year, the LLC has an allocable gain of $50, so the capital accounts of Micah and Charlsey are each increased to $125. And then depreciation of $10 is allocated to Charlsey, resulting in her capital account being $115, while that of Micah is $125. If the operating agreement provides that the members vote in proportion to positive capital accounts, then on any matter requiring the approval of a majority of the members, Micah has the controlling vote. This turn of events may well come as a surprise to Charlsey.

Mixing Different Apples with Different Oranges–Liquidation

The disconnect between state law and federal tax law may be most clear at dissolution, as here there will come into play state law directives as to the distribution of net assets, they being based upon "contributed capital," and the tax code's requirements, they being based upon capital accounts.

Under the Kentucky LLC Act, after satisfaction of outstanding liabilities and claims for declared but unpaid distributions, the LLC's net assets are distributed to the members to "return their contributions" and last to the members in proportion to their pre-dissolution rights to share in distributions.[16] The Indiana Business Flexibility Act directs that after creditor claims are satisfied and outstanding obligations for declared but unpaid distributions are met, company assets are to be distributed "to the members in proportion to the returned contribution."[17] At the same time, the Internal Revenue Code dictates that liquidating distributions be made in accordance with the partner's positive capital account balances.[18] While there may be instances in which the same net effect results, most often the two formulae will yield different results.

A capital account is a dynamic figure, being cash contributed plus the fair market value of property contributed plus allocated income less cash distributions made, less the fair market value of property distributed less allocated expenditures less allocated loss and deduction with some additional clean-up rules applied.[19] In contrast, a state law "contribution" is static—a $1,000 cash contribution is a $1,000 cash contribution irrespective of the LLC's fortunes.

Assume Mary and Jeremy form an LLC, never adopting an operating agreement but each contributing $5,000 to the venture. On day one:

Table 1

	Capital Account	Contribution
Mary	$5,000	$5,000
Jeremy	$5,000	$5,000

The business is quite successful, generating significant cash income. Over several years, the LLC makes no distributions except equal payments to Mary and Jeremy to avoid phantom income. At the end of year five, the capital accounts are as follows:

Table 2

	Capital Account	Contribution
Mary	$350,000	$5,000
Jeremy	$355,000	$5,000

On the first day of year six, Mary asks that the Company distribute to her $300,000 for a house she wants to buy. Jeremy agrees, but takes no equivalent distribution—he has no need for cash and is happy to leave funds in the company. The capital accounts are now:

Table 3

	Capital Account	Contribution
Mary	$50,000	$5,000
Jeremy	$350,000	$5,000

The next day, for whatever reason, Mary and Jeremy decide they truly loathe one another, and they agree the LLC needs to be wound-up and liquidated immediately. But on what basis? Jeremy will insist that the rules of the tax code control and that he should get 87.5 percent of the LLC's assets on the basis that as of the date of dissolution his capital account reflected 87.5 percent of the total capital accounts.[20] Mary, on the other hand, says everything needs to be split equally in accordance with their respective contributions to the LLC's capital. Jeremy responds, correctly, that "this is how the tax code says you do it." In response, Mary, correctly, retorts that "the tax code only addresses how you tax what you do—it doesn't set out any mandatory rule. That is what the LLC Act does." And so begins the battle.

Why Not Tie Them Together?

Some may wonder why this divergence is allowed to exist, and why the various LLC Acts are not written to incorporate and follow the rules of partnership taxation. Setting aside the drafting complexity, there is the practical answer that not all LLCs are taxed as partnerships. Many are disregarded entities, some are taxed under Subchapter C and some under Subchapter S.[21]

Conclusion

In the epic movie *The Last Emperor*, Mr. Johnson, tutor to the young Emperor Pu Yi, advised that "If you do not say what you mean then you will never mean what you say." This is good advice, especially when drafting partnership and operating agreements. Keep in mind, however, that in order to say what you mean, you must understand what it is you are saying. The various LLC acts, in allocating economic and voting rights in proportion to "capital contributed," do little to support a drafter in providing meaning as to what is being said and alternative allocation formulae such as in proportion to positive capital accounts are just as misleading. Careful drafting after consideration of the circumstances of the deal at hand are necessary.[22]

Endnotes

1 *See* Thomas E. Rutledge, State Law & State Taxation Corner, *Allocating Voting and Economic Rights in LLCs: An Invitation to Confusion (Part I)*, J. Passthrough Entities Nov.–Dec. 2013, at 59.

2 *See* Reg. §301.7701-2.

3 *See, e.g.*, Thomas E. Rutledge, Steven M. Lukinovich and Mark S. Franklin, *Organizing a Professional Practice: An After-Tax Choice of Entity Calculus*, 110 J. Tax'n 135 (Mar. 2009). Note, however, that the analysis there set forth is already dated, not incorporating, for example, marginal income tax rates in effect as of January 1, 2014, as well not addressing the tax imposed by Code Sec. 1411.

4 The working of the substantial economic effect test is well beyond the scope of this brief introduction. It bears noting, however, that the "substantial economic effect test" is, itself, something of a misnomer. The test actually requires that allocations be "substantial" and that they have "economic effect." It would perhaps be better labeled the "substantial and economic effect test."

5 Any such allocation will qualify under this "alternate test" for economic effect only to the extent that it does not cause or increase a deficit balance in such member's capital account as of the end of the company's tax year to which such allocation relates.

6 For purposes of this example, assume it is early 2007 and banks will lend without collateral.

7 For purposes of this example, it is assumed that the nonrecourse debt is itself not "qualified non-recourse debt."

8 *See, e.g.*, Del. Code Ann. tit. 6 §18-303(a). Ind. Code §23-18-3-3(1); Ky. Rev. Stat. Ann. §275.150(1); Rev. Prototype LLC Act §304, 67 Bus. Law. 153; and Rev. Unif. LLC Act §304(a), 6B U.L.A. 475 (2008).

9 *See* Reg. §1.704-1(b)(2)(iv)(*l*).

10 This is an important and oft overlooked point, namely that a negative capital account can be created even without special allocations. In the example above, there existed no special allocations in the Bob and Scott LLC.

11 *See* Reg. §1.704-1(b)(2)(iv)*(d)(2)*.

12 *See* Reg. §1.704-1(b)(2)(iv)(*c*).

13 Heather will bear this burden regardless of whether the LLC allocates per capita, in proportion to capital received or in accordance with capital accounts.

14 It turns out that the Tel Aviv Christmas Ham Company, LLC's business plan was less sound than they anticipated.

Endnotes

[15] Our purpose is not to examine whether this allocation is legitimate as having substantial economic effect, but to consider the state law effect of what was done.

[16] Ky. Rev. Stat. Ann. §275.310.

[17] Ind. Code §23-18-9-6.

[18] *See* Reg. §1.704-1(b)(2)(ii)(*b*)(*2*). This assumes that the LLC's operating agreement is drafted to meet safe harbors contained in the Code Sec. 704(b) regulations.

[19] *See, generally,* Reg. §1.704-1(b)(2)(iv)(B).

[20] 350,000 ÷ 400,000 = 87.5.

[21] *See also* Thomas E. Rutledge, State Law & State Taxation Corner, *S Corp LLCs—Planning Opportunity or Solution in Search of a Problem?*, J. Passthrough Entities Jul.–Aug. 2012, at 37.

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