

Operating Agreements for Emerging Growth LLCs: A Deal Lawyer's Perspective on Tax Provisions

by Steven J. Keeler

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I began my career as a tax lawyer and evolved into a transactional lawyer, over time handling a diverse mix of merger and acquisition, private equity, and venture capital transactions. The year I started practicing, the Tax Reform Act of 1986¹ was enacted. Less than five years later, Virginia enacted the Virginia Limited Company Act.² Having practiced law through the bursting of the tech

bubble at the beginning of this decade³ and the recent credit and banking crises,⁴ I am struck by the enduring impact these laws have had on the practice of business law in Virginia. And after living with limited liability companies (LLCs) for almost two decades, I try to bring a more balanced perspective to drafting operating agreements that cover the essential tax bases without making them too complex and expensive for our clients.

Enduring LLC Popularity

The LLC continues its dominance as the business entity of choice for income tax planning purposes.⁵ Small business, real estate, and investment concerns traditionally formed as partnerships were the earliest adopters. Now many venture-capital-backed, service, and technology companies are choosing the LLC form. And this choice is not only made by company founders at the formation stage, but, increasingly, later, when more tax-wary private equity investors demand that a corporation's business be transferred to a new LLC as a condition to their investment of capital.⁶

In contrast to simpler partnerships with equal and similarly-situated partners, the modern-day LLC includes companies traditionally structured as corporations and members with different contribution obligations and the economic rights that follow. Company founders and employees contribute their services and intellectual property to the LLC, while one or more investor members contribute cash.⁷ Unlike an S corporation, LLCs permit businesses to combine the state law benefits of corporations with the tax flexibility of partnerships.

Flexibility Spells Complexity

This flexibility introduces complexity in drafting LLC operating agreements—a complexity not usually confronted by attorneys drafting corporate articles of incorporation, bylaws, and shareholder agreements. LLC drafting can be frustrating to us and our clients. When we prepare the operating agreement (or review and negotiate one prepared by another attorney), we must first make certain we and the members understand their intended business deal, including their sharing of capital, profits, losses, and proceeds of a company sale.⁸ Then the tax-related provisions of the operating agreement should be tailored to ensure that the tax effects of the LLC's formation, operation, and ultimate sale or liquidation do not inadvertently alter the business deal intended by the members.

The tax benefits to the members and future financing and transaction flexibility afforded the company are well worth the drafting challenge. The process can be navigated for most clients by adopting certain drafting protocols (even forms) and, when necessary (or always if the drafting business lawyer is not comfortable with partnership taxation), consulting with tax counsel and the company's accountants during preparation of the operating agreement.

A Good Starting Form Gets it Right, and Readable

No one form fits all situations. Significant drafting errors can occur when technical tax boilerplate is ignored, or a form more appropriate for a real estate development partnership or hedge fund is used for an operating company structured more like a corporation. That said, in my experience good and efficient drafting starts with a set of defined terms and tax provisions with which the draftsman is familiar and which have proven effective in prior deals. With these as a start, a good form can be tailored to the current client's situation and objectives, provided the business deal and the tax effect are clearly understood.

Use a Corporate Model for the Business Deal

In my experience, it is much more efficient to draft operating agreements governing service, property, and investor members by using terminology similar to that used in corporate venture capital deals.⁹ First, entrepreneurs, investors, and third parties are familiar with terms such as "shares" (versus "interests," and including common and preferred classes), and "directors" (versus "managers"). Second, compared with the terms "interest" or "membership interest" (borrowed from the statute and partnership forms, and describing a member's LLC equity as a contribution-driven or percentage concept), the use of terms such as "shares" or "units" simplifies the designation of the different equity classes and the tracking of changes in the LLC's membership. Of course, the terminology is not completely transferable. To distinguish membership interests from corporate stock, I typically refer to LLC membership interests as "units." And to preserve the important tax distinction between partnerships and corporations, I never refer to LLC distributions as "dividends." I refer to the LLC as the "company," and not the "corporation." Although not legally required, I refer to the most junior class of units as "common" units. Units such as investor units that have priority, preference, or preferential rights senior to the common units are "preferred" units.

Put the Tax Terms and Tax Boilerplate in Their Place

Of course, even with corporate terminology that the members can understand quickly in the context of their business deal, the operating agreement must also borrow tax terminology from the partnership model (the principal drafting implications of which are the need to distinguish unit

ownership from capital accounts, and allocations of profit and loss from cash distributions). A well-drafted operating agreement will include relatively standard provisions designed to incorporate or take advantage of certain elections in the income tax regulations that govern partnerships.¹⁰ I put these in an appendix to the operating agreement so they do not overwhelm and distract my clients from the more important business terms of the operating agreement. Some of these regulatory provisions and definitions are not necessary for every deal, but without a crystal ball to predict the LLC's future profit-and-loss results, debt and equity structure, and other transactions or events that may have partnership tax consequences to the members, I am more comfortable having the important boilerplate in the operating agreement in case it is ever needed.

More fundamental to the business deal than the regulatory boilerplate are the defined terms that marry the LLC's tax status to the members' intended economic deal. The defined terms can also be incorporated into an appendix. The best drafting protection of the business deal against inadvertent and unintended tax effects are relatively standard and consistent definitions of "profits," "losses,"¹¹ "capital accounts," and "book basis" (or "gross asset value").¹² My definitions of these critical tax terms (and equally important business terms such as "units," "capital contributions," and "distributable cash," or what is sometimes referred to as "net cash flow" or "cash available for distribution") change very little from agreement to agreement, because they have withstood the scrutiny of my tax partners and many accountants who prepare the tax returns for our LLC clients.

What's the (Distribution) Deal?

Money Talks: Start with the Investor Members.

Investor members recognize no gain or loss on the contribution of money to the LLC in exchange for LLC units.¹³ The operating agreement should credit each investor member with both a capital contribution and capital account equal to its money contribution, as each of these will drive the distribution rights of the investor member. If the investor member demands preferred units, these will typically entitle the investor member to receive a return of its entire capital contribution (always from liquidating and often from operating distributions; these, together with any preferred return, are called a "liquidation preference"), plus an additional amount

representing “interest” or a specified return on its unreturned capital contribution (most often cumulative, and called a “preferred return”). Therefore, the distribution section of the operating agreement usually should provide for the distribution of available cash—first to the investor members in an amount equal to their capital contributions and any cumulative preferred return that have not previously been repaid, and thereafter to the investor, service, and property members in proportion to their percentage ownership of units. Some service and property members can successfully negotiate to limit the investor members’ right to receive the return of their capital contributions and any preferred return to a liquidation preference payable only upon a sale and liquidation of the company.¹⁴

Property (Including IP) Contributors

Occasionally, the investor members are willing to place a value (that is, an agreed book basis) on intellectual property contributed to the LLC by a property member (who might also be a service member). While this will result in the property member being credited with a capital contribution and capital account having an equal value, the property member would most often receive common, and not preferred, units in exchange for the intellectual property, putting the property member on equal footing with the service members for future operating distributions (although depending upon the value of the intellectual property and the property member’s leverage, preferred units might be negotiated). The tax law requires that LLC allocations account for the difference between the property member’s tax basis in the contributed intellectual property (typically its cost) and the agreed value to be reflected in the property member’s capital account.¹⁵

This allocation rule is mandatory and trumps the general allocation provisions of the operating agreement. Although more relevant to the regulatory and allocation provisions of the operating agreement, perhaps the most important drafting implication of contributions or revaluations of appreciated property is the ability to select from among several allocation methods prescribed by the tax regulations.¹⁶ Although beyond the scope of this article, depending upon the context and the numbers involved, the selected allocation method can materially impact the after-tax economic effect to the service, property, and investor members, respectively. Even if there were no property member upon the LLC’s formation, a well-drafted operating agreement should address

the tax and accounting implications of in-kind property distributions to deal with the possibility of future contributions (including, as is relatively common for venture-backed companies, property contributions in connection with the LLC’s acquisition of other businesses in exchange for units).

Service Contributors: Planning with Profits Interests

Most of our growth-company LLC clients grant common units or options to acquire common units to service members, both at formation and later when new talent is hired.¹⁷ Although beyond the scope of this article—because they can be received without current tax consequences to the service member, require no purchase or payment by the service member, and do not raise other tax issues associated with options,¹⁸ we will assume that the service provider is granted actual common units, rather than being required to purchase the units for cash or a note, or being granted options to purchase units in the future.

If possible and otherwise consistent with the members’ business objectives, to avoid current taxation to the service member on the receipt of his or her common units in exchange for services, steps should be taken to maximize the likelihood that the units will be treated as a profits interest for tax purposes.¹⁹ I have encountered significant confusion among clients and business lawyers who are under the impression that profits interests must be designated as a separate class of units in the operating agreement for state law purposes. The simplest drafting dictates that the service member just be granted common units as defined in the operating agreement. To ensure these units will be respected as nontaxable profits interests, the draftsman should confirm that the aggregate capital accounts of the other members (after any permitted restatement or book up) equals or exceeds the company’s then-fair market value (or going concern or enterprise value) and provide that liquidation distributions will be made in accordance with the members’ respective capital accounts. Because of the likely nominal initial value of common units, the grant of profits interest upon an LLC’s formation does not usually present any issues, provided the operating agreement does not permit the recipient to receive any portion of the property and investor members’ capital accounts upon a hypothetical liquidation. If, as is often the case, business negotiations or different drafting practices require that the operating agreement provide for liquidation distributions in accordance with unit ownership instead

of capital account balances, then the draftsman should confirm that the then-unpaid liquidation preference of any investor members equals or exceeds such company value such that the service member would not, on the date of his receipt of the common units, be entitled to any share of the sale proceeds in respect of his percentage ownership.

The planning for profits interests is somewhat uncertain in that, regardless of operating agreement terms, the law has continued to evolve and tax results depend upon subjective valuation principles.²⁰ In general, however, at least until future legislation or regulations provide otherwise, provisions mandating liquidation distributions in accordance with capital accounts should provide the best protection to service members, provided the other members' capital accounts then reflect the company's full value and, it follows, the service member's capital account is zero. Alternatively, if the service member can be recast as a property member based upon a contribution of intellectual property or other assets, this may provide a further hedge against the tax risk. Although not technically required under current law, prudence dictates that service members make an 83(b) election,²¹ and lawyers should consider including provisions that would enable the LLC to elect a liquidation value safe harbor under not-yet-finalized Department of Treasury regulations and an IRS notice, to avoid having to obtain member consents to conforming amendments in the future if and when the regulations and procedures are finalized.²²

Tax Distributions

Most operating agreements will include provisions that obligate the LLC to make distributions to the members at times and in amounts sufficient to enable them to pay their income taxes (including estimated taxes) attributable to their allocable share of LLC profits. For the sake of convenience, my typical operating agreement tax provision assumes that each member's share of profits constitutes their only taxable income and that such income was taxable at the highest federal marginal rate in effect for the applicable year, plus some fixed rate (e.g., 6 percent) for state and local taxes. To avoid inadvertent excess distributions, the tax distribution provision should be clear that any tax distributions offset, or are considered an advance against, the next distributions payable to the receiving member pursuant to the operating distribution scheme.

Preserving the Distribution Deal with Proper Allocation Provisions

Capital Accounts Versus Membership Interests

The concept of a capital account is the client's first clue that an LLC involves not-so-parallel book and tax universes. I often describe the capital account as a thermometer (the red line goes up with capital contributions and profit allocations, and goes down with loss allocations and distributions), and the key to ensuring that the members' economic arrangement can be carried out through a tax-efficient pass-through entity. The § 704(b) regulations²³ referenced in good operating agreements tax provisions are designed to ensure that allocations of LLC profits, losses, and other tax items to the members will impact them economically (that is, will affect the amount of distributions they will ultimately receive from the LLC). The capital account concept and maintenance rules are the engine of the § 704(b) regulations. Distributions of cash²⁴ and allocations (of profits — whether or not distributed — or losses — as reflected in the forms K-1 issued to the members) are not the same thing and may be divided differently among the members from year to year. Properly maintained capital accounts ensure that, over the life of the LLC, the total distributions to each member will equal, to the extent possible, such member's capital contributions, plus such member's aggregate profits allocations, less such member's loss allocations.

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Given the fundamental importance of capital accounts to the process of correlating economic (book) and accounting (tax) income, the operating agreement should define the capital account of each member and describe the determination of such capital account with specific reference to the regulatory maintenance rules.²⁵ Furthermore, to avoid economic distortions resulting from future contributions and distributions of LLC property (which will usually have a tax basis different from its fair market value), and to permit member capital accounts to be increased or

decreased to reflect a revaluation of LLC property (which can be important not only to the members' intended business deal but also the characterization of a service member's units as a profits interest), in connection with a distribution in redemption of a member, a contribution of a new member, the liquidation of the LLC, or the grant of an LLC interest in connection with the performance of services, the operating agreement provisions defining capital accounts, profits, and losses should incorporate a book basis (gross asset value) concept.²⁶

Allocation Provisions: Choosing Between Tiered or Targeting Styles

With proper capital account definitional and maintenance provisions built in to every operating agreement, the draftsman can then focus on making sure that the allocation provisions not interfere with the business intent of the distribution provisions. I find it helpful to design allocation provisions with the end—the operating agreement's liquidating distribution provisions—in mind. I have heard it said that more traditional operating agreement provisions mandating liquidation distributions per capital accounts “capital account provisions,” while providing more tax certainty, increase the risk of drafting errors that may cause inadvertent changes in the business deal. On the other hand, waterfall-style liquidation distribution provisions (similar to the tiers governing operating distributions), which seem to have become more common in recent years, are

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thought to introduce tax uncertainty but avoid business deal mistakes. Over the years, I would estimate that roughly half of my operating agreements employed capital account provisions and half unit percentage provisions. There is no one right approach. The important thing is that the allocation, operating distribution and liquidating distributions work in concert to comply with tax law and achieve the members' business deal.²⁷

Older operating agreement forms tend to employ multiple layered tiers of allocations corresponding to the operating distribution provisions. The more complicated the business deal, the more

complicated are these types of allocation provisions. Because an LLC's members will generally focus on the operating agreement's distribution provisions to confirm that they achieve their economic deal, and rely on the lawyer to tailor the operating agreement with appropriate allocations provisions, I have increasingly defaulted to an allocation provision popularly described as “targeting” capital accounts. Such a targeting provision allocates profits and losses each year in a manner such that the members' capital accounts will equal, as closely as possible, the amounts they would be entitled to receive (under the operating distribution scheme of the operating agreement) were the company's assets sold for their book basis and the proceeds distributed to the members in liquidation of the LLC.

Expecting the Unexpected

Test Drive Your Distribution and Allocation Provisions

Even with significant expertise in partnership tax and experience drafting operating agreements, the prudent draftsman will request profit-and-loss projections and future assumptions from the client and test the operating agreement by preparing spreadsheets of liquidating distribution outcomes based upon numerous profit, loss, financing, and exit scenarios. These projected operating agreement results should be reviewed with input from the client and the likely tax return preparer to minimize the risk of future misunderstandings.

Savings Clauses

Perhaps the greatest indication that there may be no perfect operating agreement in terms of coordinating the members' business deal with partnership tax law, many well-drafted operating agreements include a savings clause. Such a clause states the members' intent that the allocation provisions are intended to result in capital account balances and liquidating distributions that comport with the their business deal regarding distributions and, to the extent that objective is not achieved, permits the LLC's manager or governing board to amend the operating agreement to permit reallocations of prior, open years' profits and losses for the purpose of more closely achieving the intended economic result.

Talk to the Tax Return Preparer

Depending on whether the client is the LLC or a controlling member to avoid the risk of future

questions, professional disagreements and amendments, it is advisable to seek the input and approval of the LLC's accountant or tax return preparer regarding the operating agreement's distribution, allocation, definitional, and regulatory tax provisions in the context of the preparation of the LLC's returns.

Common Partnership Tax Red Flags

It is helpful for LLC counsel to be aware of business or transaction scenarios that may create unanticipated tax issues for the members. While some of these are addressed in more complex operating agreements, especially when the issues arise in connection with the LLC's formation, the standard operating agreement is not usually dispositive of these issues.

LLC Liability Issues

In contrast to S corporation shareholders, LLC members benefit from the fact that they can include their share of LLC liabilities in their outside basis in their LLC membership interest. But this benefit can create unanticipated income tax consequences. Always look for transactions (including routine LLC borrowings, debt repayments, guarantees or releases therefrom), property contributions and distributions, and changes in the LLC's membership that might result in a change in the members' respective shares of LLC liabilities. Generally speaking, members share recourse debt in proportion to their economic risk of loss. So-called partner nonrecourse debt or a nonrecourse liability for which one member bears the economic risk of loss (for example, because such member made or guaranteed the loan to the LLC) are included in the definition of recourse debt. Members generally share nonrecourse LLC debts (that is, those for which no individual member or members have the risk of loss) in proportion to their interests in LLC profits.²⁸ A reduction in a member's share of LLC liabilities is treated as a distribution of cash to the member and, to the extent the amount of such deemed distribution exceeds the member's basis in its membership interest, can trigger taxable gain to the member.²⁹

Capital Account Book Ups

I have mentioned the circumstances in which LLC asset revaluations and capital account restatements or book ups are either required or permitted under the § 704(b) regulations. Counsel should consider the advisability of such revaluations and seek the input of the LLC's tax return

preparer whenever an LLC interest is issued or redeemed in consideration of a contribution or distribution, respectively, of money or property, an LLC interest is granted as consideration for services (particularly if the interest is intended to be a profits interest), or the LLC is to be liquidated.³⁰ When capital accounts of the existing members are booked up in connection with the grant of an interest to a new member that is intended to be treated as a profits interest, allocations of future gain in the amount of such book up are required to be made to the existing members pursuant to so-called "reverse § 704(c)" allocations.³¹

Disguised Sales

Some otherwise tax-free contributions of property to LLCs may be taxable in whole or in part as "disguised sales" if made in connection with related transfers, or around the time of other transfers (for example, within two years), of money or other consideration to the contributing member.³² If a disguised sale is identified in connection with an LLC formation, operating agreement provisions may be drafted in a manner to optimize the impact of the regulations governing such transactions.³³

Convertible Notes Member Loans and Guarantees

It is common for companies in need of venture capital to occasionally issue convertible notes instead of preferred units. Notes are often used either to address emergency cash needs or to defer the question of the company's valuation until a future round of equity financing. Assuming the convertible notes are respected as debt, the lawyer needs to consider the fact that a nonmember note holder will not be treated as a partner for tax purposes and the implications of this fact both for the terms of the units into which the note is convertible (including the parties' intent regarding profit and loss allocations during the term of the note) and the distribution and allocation provisions of the operating agreement. Furthermore, a note conversion should be carefully planned to address the potential recognition of debt cancellation income.³⁴ If an existing member makes or guarantees a loan to the LLC, the loan will constitute partner nonrecourse debt with respect to the lender-member under § 752 and, as a result, impact LLC loss allocations.³⁵ However, the characterization of such partner nonrecourse debt as recourse or nonrecourse under § 1001 for purposes of the cancellation of indebtedness consequences is less certain.³⁶ ■

Endnotes:

- 1 Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2277 (86 Act). The 86 Act and subsequent legislation reduced the gap between the maximum marginal income tax rates applicable to LLC members (who, as partners in a partnership for tax purposes and, similar to S corporation shareholders, pay the taxes on the LLC's income) and corporations, respectively. An LLC is subject to a single, member-level tax on its earnings, whether or not earnings are distributed, whereas a C corporation's distributed earnings are subject to a double tax (i.e., at both the corporate and shareholder levels). The ability of an LLC to sell its assets in a taxable transaction with only one level of tax offers considerable flexibility given the difficulty in predicting the timing or manner of a company's exit years into the future.
- 2 Va. Code § 13.1-1000 *et seq.* Virginia was one of the first states to adopt the LLC, although LLCs are now recognized in all states.
- 3 The most significant byproduct of the 2001 market correction was the closing of the initial public offering (IPO) market as an exit alternative for relatively small and early-stage companies formed, in part with an IPO in mind, as C corporations.
- 4 The biggest impact of the credit and banking crises on the business lawyer's practice has been the unavailability of bank debt to fund company growth and acquisitions.
- 5 LLCs are generally treated as partnerships for federal and state tax purposes, thereby avoiding the restrictive ownership and capital structure requirements of S corporations and the double-tax regime governing regular C corporations. Because an LLC can be later converted to a corporation (note, the reverse is not true), LLC property can generally be distributed to members, and an LLC can generally effect a spin-off, each on a tax-deferred basis, an LLC can more often navigate future transactions that are difficult to predict on a tax efficient basis.
- 6 Thanks to IRC § 721, a drop-down of corporate assets can be often accomplished on a tax-deferred basis and, in the case of an S corporation target, if handled carefully (through the use of a QSUB conversion to a single-member LLC subsidiary to avoid any taxable conversion or liquidation of the S corporation or QSUB), may even be accomplished without any need to transfer assets.
- 7 Depending upon the industry, life-cycle stage and profile of the company, the investors might include employees, high net-worth individuals known as "angels," or venture capital or private equity funds.
- 8 Of course, the initial draftsman will typically represent only the service or property members and/or the company, on the one hand, or the investor members, on the other, so the final operating agreement provisions will reflect the input of and negotiations with counsel to the other parties.
- 9 The company capital structure contemplated by a standard venture capital "term sheet" includes common stock (or stock options or restricted stock subject to vesting restrictions) for the service and property members (and perhaps prior "friends and family" investor members), preferred stock for the investor members having seniority with respect to return of capital, dividends and liquidating distributions, and often preferential "co-sale," "drag-along," "put," preemptive and other transfer rights.
- 10 These "regulatory" provisions ensure operating agreement compliance with Reg. § 1.704-1(b)(2)(iv), and include "minimum gain chargeback," "qualified income offset," § 754 election-related provisions, a negative capital account avoidance provision, and other tax accounting provisions which, in my experience, are valuable reminders when you need them, particularly when explaining and interpreting the operating agreement for the LLC's tax return preparer.
- 11 The "industry-standard" definition for profits and losses starts with net taxable income or loss determined in accordance with applicable tax accounting methods, accounts for tax-exempt income and nondeductible expenditures, excludes the regulatory or any special tax allocations and, perhaps most important in reconciling the economic (book) terms of the operating agreement (which are ultimately reflected in the capital accounts) with the tax treatment, substitutes the "book basis" (gross asset value) concept for the tax basis (reflecting a "mark-to-market" approach) of the LLC's assets for purposes of calculating future depreciation of, and gain or loss on sale of, LLC assets.
- 12 See discussion under "Capital Accounts Versus Membership Interests" below.
- 13 IRC Section 721(a).
- 14 When investor members holding units of the same class have invested at different times and at different purchase prices, consideration must be given to providing for distribution of the liquidation preference among them based upon the amounts of their respective preferences rather than their number of preferred units.
- 15 IRC § 704(c) (which is designed to prevent the shifting of tax consequences of pre-contribution gain or loss among members) and Treasury Regulations (Reg.) § 1.704-3. This section also applies to capital account restatements, revaluations or so-called "book ups" to reflect the true value of LLC assets upon the admission of new members.
- 16 Reg. § 1.704-3(b) ("traditional method"), (c) ("traditional method with curative allocations") and (d) ("remedial method").
- 17 In lieu of the "subscription agreement" memorializing the investor member's money investment and the "contribution agreement" evidencing the property member's in-kind contribution, it is advisable to have a Unit "award" or "option" agreement (sometimes supplemented by an equity "plan" document) separate from the operating agreement to include provisions governing the vesting (e.g., employment or time-based, or "milestone," or performance-based, vesting) and transfer (including any company right to repurchase the service member's units upon termination of employment).
- 18 Like corporate stock options, options to purchase LLC units are less tax efficient to the service member because the "spread" between the exercise price and fair market value of the units upon exercise is taxed as ordinary, compensation income to the service member. Furthermore, IRC § 409A, which can accelerate income recognition and trigger penalties in respect of certain option grants, does not apply to grants of restricted property (including LLC capital or profits interests) subject to IRC § 83.
- 19 A "profits interest" is an interest that would not entitle the holder to a share of the proceeds if the LLC's assets were sold for their fair market value and the sale proceeds were distributed to the members in liquidation of the LLC, determined as of the time the profits interest is granted. Rev. Proc. 93-27, 1993-2 CB 343. See also Rev. Proc. 2001-43, 2001-2 CB 191.
- 20 Proposed Treasury Regulations and IRS notice issued in 2005 would generally not distinguish between profits and capital interests, but would provide an elective "safe harbor" pursuant to which compensatory LLC interests could be valued based upon their liquidation value. Lawyers should consider the inclusion of this election in operating agreements even prior to finalization of the proposed regulations. In any event, with proper planning and drafting, tax-free grants of LLC interests should still be possible after enactment of the proposed regulations. REG-105346-03, 70 Fed. Reg. 29675 – 29683 (May 24, 2005); Notice 2005-43, 2005-24

- I.R.B. 1221 (which, if finalized, would make the Rev. Proc. 93-27, 1993-2 CB 343 and Rev. Proc. 2001-43, 2001-3 CB 191 obsolete). See also, e.g., Prop. Regs. § 1.83-3(e) and -6(b), 1.707-1(c), 1.704-1(b)(2)(iv)(b)(1), 1.721-1(b)(2), and 1.761-1(b).
- 21 IRC § 83 allows the recipient of an unvested equity interest in connection with the performance of services to elect to include the Robertson, Tracy (DOE) [Tracy.Robertson@doe.virginia.gov] value of the interest in gross income. The election must be made within 30 days of the date the interest is received, and ensures that (a) any appreciation in value of the interest from the date of grant through the vesting date will be taxed as capital gain and not as compensation income, and (b) that the recipient will be deemed to be a “partner” of the LLC for tax purposes.
- 22 See footnote 21 above.
- 23 Reg. § 1.704(b).
- 24 It is important to note that salary-type (guaranteed) and other payments to members not in respect of their units are not treated like distributions: they do not reduce a member’s capital account and are taxable without regard to the member’s basis in his or her units. See IRC § 707(a) and (c).
- 25 See specifically Reg. § 1.704-1(b)(2)(iv).
- 26 See generally Reg. § 1.704-1(b)(2)(iv)(d)(1), -1(b)(2)(iv)(e)(1), -1(b)(2)(iv)(f) and § 1.704-3.
- 27 Provisions requiring liquidation distributions per capital accounts should simplify the planning for future profits interest grants after formation of the LLC, as capital accounts can be restated and the operating agreement requires no amendment. Unit percentage distribution provisions, on the other hand, would require amendment to ensure the distribution tiers reflect the “mark-up” in the revalued LLC assets. See generally Reg. § 1.704-1(b)(2)(iv)(f)(5)(iii) (permitting capital account “book ups” in connection with LLC interest grants).
- 28 Actually, members share non-recourse debt in proportion to, first, their share of LLC “minimum gain,” second, their share of “§ 704(c) minimum gain,” and, finally, their interest in LLC profits. IRC § 704(b) and 752; Reg. § 1.704-2(i) and 1.752-3(a).
- 29 See IRC § 731(a)(1).
- 30 § 1.704-1(b)(2)(iv)(f).
- 31 *Id.*
- 32 IRC § 707(a)(2).
- 33 Reg. § 1.707-3 and -4. Through careful drafting around extremely technical rules, distributions can be structured as guaranteed payments, preferred returns, operating distributions and pre-formation expense reimbursements in an attempt to avoid the disguised sale rules.
- 34 IRC § 108(d)(6).
- 35 Reg. § 1.704-2(i).
- 36 Reg. § 1.1001-2(c).