

**JOHN CUNNINGHAM'S LLC NEWSLETTER
FOR TAX AND LEGAL PROFESSIONALS**

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**WHAT FEDERAL TAX PROVISIONS SHOULD BE
INCLUDED IN THE LLC AGREEMENTS OF MULTI-
MEMBER LLCs TAXABLE AS PARTNERSHIPS—
AND WHY?**

EXECUTIVE SUMMARY

Before you can decide what federal tax provisions should be included in the LLC agreement of a multi-member LLC taxable as a partnership, you should define the purpose (or purposes) of these provisions; and you should include in the agreement all of the provisions—and only the provisions—that are necessary to fulfill these purposes.

DISCUSSION

About half of all LLCs are multi-member LLCs—i.e., they have two or more members. A very substantial majority of these multi-member LLCs are taxable as partnerships under Internal Revenue Code Subchapter K. As every accountant knows, Subchapter K is one of the most complex parts of the Internal Revenue Code, and the federal tax provisions in many LLC agreements—including even the very large number of those LLCs that have very simple economic and tax arrangements—can be dauntingly complex. Indeed, the “tax boilerplate” in these agreements—often inserted by lawyers in LLC agreements without any understanding of what it means—is likely to be unintelligible to anyone except a partnership tax specialist.

In future issues of this newsletter, I will write about the various specific federal tax provisions that I believe should be in the LLC agreements of LLCs taxable as partnerships. However, it is obvious that the starting point in identifying these provisions must be to determine the *purposes* that these provisions should fulfill. I suggest that there are five such purposes.

- 1) The federal tax provisions of the LLC agreement of an LLC taxable as a partnership should state the tax deal in a manner that is accurate, comprehensive and legally enforceable in court. Thus, for example, in those few cases where one or more members want “special allocations”—i.e., allocations of income, losses or other tax items disproportionate to their share of aggregate contributions or capital accounts or otherwise inconsistent with their interest in the LLC—these special allocations should be accurately stated.

- 2) To the extent possible, the federal tax provisions of the LLC agreement should be such as to enable the members to understand the economic and tax deal and to make sure the deal is what they want. In general, this means that all tax and economic terms should be stated as clearly as possible and that any tax terms whose meaning isn't likely to be clear to the members are defined in plain English (and explained verbally to the members by their legal and tax professionals if necessary or helpful). It also means that the agreement should not contain abstruse tax boilerplate that the members won't understand unless this boilerplate is absolutely necessary to the deal.
- 3) The federal tax provisions of the LLC agreement should be such that, if an IRS agent or state tax official ever audits the LLC, they will give the official an initial sense that the LLC is probably complying with applicable tax rules. To achieve this effect, the LLC agreement should contain, among other things, clearly stated rules for the maintenance of capital accounts and for the liquidation of the LLC in accordance with capital accounts. Furthermore, much as I hate to admit it, the agreement should generally contain a "qualified income offset" provision (a "QIO"), since, whether reasonably or not, tax officials generally expect to find such a provision in the agreement or, in its place, they expect to find a "deficit restoration obligation" (a "DRO"). (I'll explain the meaning of the quoted terms in a soon-forthcoming issue of this newsletter.)
- 4) The federal tax provisions of the LLC agreement should provide clear guidance to tax accountants and other tax advisers as to how to answer members' partnership tax questions after the LLC begins business and as to how to prepare tax returns for the LLC. Thus, for example, if a member has contributed to the LLC real property with a built-in pre-contribution gain, the LLC agreement should make clear that tax accounting for the LLC must follow the regulations under IRC Section 704(c)(1)(A) and, in particular, the agreement should specify which of the three allocation methods under those regulations—the "traditional method," the "traditional method with curative allocations" or the "remedial method"—should be used to do tax accounting in respect of the property.
- 5) The federal tax provisions in the LLC agreement should be such as to maximize tax compliance by the LLC and its members. In my view, this means that the agreement should, among other things, require the members (a) to appoint a tax adviser who is reasonably expert in partnership taxation; and (b) to consult with this adviser before undertaking any major LLC transaction (such as a sale or issuance of an LLC membership).