

JOHN CUNNINGHAM'S LLC NEWSLETTER FOR TAX AND FINANCIAL PROFESSIONALS

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HOW TO EXPLAIN CAPITAL ACCOUNTS TO YOUR LLC FORMATION CLIENTS

I. INTRODUCTION

As all CPAs and Enrolled Agents who are subscribers to this newsletter are aware, LLC agreements for multi-member LLCs taxable as partnerships under Subchapter K of the Internal Revenue Code normally should contain a set of provisions relating to capital accounts. These provisions normally should:

- Define the meaning of capital accounts;
- Set forth the rules under Treasury Regulation section 1.704-1(b)(2)(iv) for computing these accounts (the “Capital Account Regulations”);
- Require the LLC to maintain capital accounts in accordance with these rules;
- Require the LLC to make distributions in liquidation of each individual member’s partnership interest in such a manner as to leave each of the members after the distribution with a zero capital account; and
- Require the LLC to make liquidating distributions to the members in connection with its own liquidation so as to zero out all members’ capital accounts.

Under the Capital Account Regulations, the LLC agreement of such an LLC should state that each member’s capital account will be:

- 1) Increased by the amount of cash contributed to the LLC by the member and by the fair market value of any contributed property (net of liabilities relating to the property that are assumed by the LLC);
- 2) Increased by LLC allocations of its profits to the member;
- 3) Decreased by distributions to the member; and
- 4) Decreased by the member’s share of LLC losses.

In my experience, most LLC formation clients don’t have the vaguest notion of what capital accounts are all about and why they are important; and many of them are annoyed at the inclusion of what they view as meaningless capital account “tax boilerplate” in their LLC agreements. However, I believe that if they can be helped to understand

capital accounts, this will give them a much deeper practical understanding of their LLC deal.

What, if anything, can we as tax professionals say to these clients to help them gain a practical understanding of capital accounts?

I suggest the 10 points summarized below.

II. WHAT TO TELL YOUR CLIENTS ABOUT LLC CAPITAL ACCOUNTS

- 1) “Forget about tax” – the primarily *economic* function of capital accounts. First, let’s forget about tax for the moment and just think about LLC capital accounts from the viewpoint of common-sense business economics. As I’ll discuss later, that’s what capital accounts are really all about anyway.

From a purely economic viewpoint, what the capital accounts of LLC members are designed to accomplish is to divide up the total equity in the LLC (very roughly, its current fair market value) among the members in a manner that reflects their *economic* deal. Broadly speaking, the idea is that if capital accounts are kept accurately, then, if at any given moment the LLC is liquidated and it makes liquidating distributions to its members on the basis of their capital accounts, each member will be assured of getting the member’s agreed-upon share of the LLC’s value.

EXAMPLE. On January 1, 2005, Able and Baker form AB, LLC, an LLC taxable as a partnership. Each of them contributes \$100, and they agree to share AB’s profits, losses and distributions equally. During 2005, AB’s net profits are \$200. This means that on January 1, 2006, Able’s capital account is \$200 – the \$100 that he originally contributed to AB and his 50% share of AB’s \$200 of profits. Baker’s capital account is, of course, exactly the same. On January 2, 2006, Able and Baker dissolve and liquidate AB. Assuming that AB has no third-party creditors, Able and Baker, in accordance with their original deal, will each receive in this liquidation the \$200 reflected in their respective capital accounts.

In other words, a “zeroing out” of these accounts will ensure that each of Able and Baker receives his agreed-upon share of AB’s fair market value upon its liquidation.

- 2) Capital accounts and “special” allocations and distributions. The importance of maintaining accurate capital accounts should be evident even from the simple example just provided; these capital accounts ensure that when AB is liquidated, Able and Baker will both get the deal they agreed upon.

However, LLCs have a fundamental statutory characteristic that, in many situations, can greatly increase the importance of maintaining accurate capital accounts. Indeed, in the case of many LLCs, this characteristic makes accurate capital accounts an absolute economic necessity; without these accounts, the members can’t accomplish

their deal.

To explain: A substantial majority of LLCs allocate their profits and losses among their members and their distributions to their members in proportion to their members' shares of aggregate contributions to the LLC.

EXAMPLE. Jones and Smith form JS, LLC, an LLC taxable as a partnership. Jones contributes \$200 to JS. Smith contributes \$100. Under JS's operating agreement, JS must allocate two thirds of its profits and losses to Jones and one third to Smith. In addition, whenever it makes a distribution of profits, it must distribute two thirds of the total distributed amount to Jones and one third to Smith.

However, no U.S. LLC act *restricts* LLCs to employing only the above "per-contribution" approach. Instead, all of these acts permit LLCs to make allocations and distributions on a "*per-contract*" basis – i.e., in any way that the members agree in working out their LLC deal. These "per-contract" LLC deals can include agreements among the members under which the allocations and distributions to which they are entitled will be "special" – i.e., disproportionate to their contributions. Furthermore, Internal Revenue Code (IRC) Sections 704(a) and (b) expressly permit and respect "per-contract" arrangements, including "special" allocations and distributions, as long as these arrangements make economic sense and aren't merely tax-motivated.

EXAMPLE. Barbara Jones forms BJ, LLC, and contributes \$100 to it. A year later, she has a desperate need for additional capital and asks John Smith to contribute \$100 in exchange for a membership in BJ. Smith agrees, but only on the condition that Smith be entitled to two thirds of all BJ profits after the date of his contribution. In other words, John Smith wants a "special" allocation that will be disproportionate to his share of aggregate contributions. Obviously, Jones doesn't like this deal. However, because Smith is the only person she has found who is willing to invest in BJ, and because she needs his investment in order to save her company, she has no choice but to accept his terms.

However, in a situation in which Jones and Smith will have equal contributions but unequal allocations, there is only one safe way to make sure that upon any liquidation of either (i) the LLC interests of Jones or Smith or (ii) BJ, LLC itself, the economics of the deal between Jones and Smith will be enforced. This is for BJ to maintain separate and accurate current capital accounts for each of Jones and Smith.

The necessity for capital accounts becomes even more evident if, as part of the deal between Jones and Smith, Smith agrees as follows:

- Although BJ will allocate two thirds of its profits to him, it will make no distributions to him until his LLC interest is liquidated or BJ itself is liquidated.
- By contrast, all amounts that BJ allocates to Jones will be immediately distributed to her.

The net effect of the above agreements will probably be that if BJ is profitable, then, when the time comes to liquidate BJ, Smith will have a substantial capital account and the zeroing out of his capital account will result in a substantial liquidating distribution to him; whereas Jones' capital account and thus her liquidating distribution will be quite small (and will perhaps even be zero).

- 3) Comparing capital accounts and bank accounts. As a good starting point for understanding your capital account as an LLC member (but *only* as a starting point), think of your capital account as bearing roughly the same relation to your LLC as your bank account bears to your bank. Your bank account at any given moment consists of your deposits (roughly comparable to your contributions to your LLC and your allocations of LLC profits) less your withdrawals (roughly comparable to your distributions from your LLC and your share of LLC losses). Needless to say, this analogy limps, since banks, unlike LLCs, don't allocate their profits or losses to their depositors, nor do they distribute bank profits to them. But the analogy is helpful nonetheless when you're trying to get a basic initial understanding of capital accounts.
- 4) Discrepancies between capital accounts and economic reality. In the real world, the total capital accounts of all of the members at any given moment usually won't exactly reflect the actual fair market value of the LLC at that moment. This is because the aggregate fair market value of the assets of virtually any LLC is likely to fluctuate to a significant degree from quarter to quarter or even from day to day. Thus, at times, this value may be much higher than the aggregate dollar value of the members' capital accounts; at other times, it may be much less.
- 5) "Revaluations." However, in five main situations, the Capital Account Regulations let the members "revalue" the LLC's assets and thus the members' capital accounts so as to reflect the LLC's actual fair market value. These revaluations are also frequently referred to as "book-ups" (if the value of the assets is increased in the revaluation) and "book-downs" (if this value is decreased). For certain of these revaluations, the IRS requires that the LLC have a special election in place. See, e.g., Capital Account Regulations, Sections 1.704-1(b)(2)(iv)(d)(1) and (1)(b)(2)(iv)(f).
 - a) LLC buy-out of a member. The first situation is when the LLC buys out a member. (In tax terms, an LLC's buy-out of a member is a "liquidation of the member's interest." In legal terms, it is a "redemption" of this interest.) At that time, the members will presumably negotiate together at arm's length to arrive at an economically acceptable buy-out price. This price, in turn, will be based on the actual fair market value of all of the LLC's assets. In connection with the buy-out, the Capital Account Regulations will permit the LLC to revalue its aggregate assets, and, correspondingly, its members' shares of this value as reflected in their capital accounts.
 - b) Liquidation of LLC. The second situation when the IRS permits revaluations is when the LLC itself is liquidated. In this situation, the actual fair market value of the LLC's aggregate assets is likely to be even clearer than in the first situation, since the sale of these assets in connection with the LLC's liquidation will fix this

- value once and for all and thus will definitively determine the final economics of the LLC deal.
- c) LLC admission of a new member. The third situation is when the LLC permits a new member to buy into it. Here, too, the price at which the new member purchases that member's membership will usually reflect the fair market value of the LLC and thus will justify any necessary revaluation of its assets and thus of the members' capital accounts.
 - d) Increase of existing member's interest through new contribution. The fourth situation is when the LLC permits an existing member to increase the member's share in the LLC by contributing new money or property. An example would be where the LLC needs more money and a member agrees to contribute it, but only if the member's share of LLC profits is duly increased.
 - e) LLC holds only securities. The fifth is when substantially all of the LLC's non-cash assets are stocks, securities, options, and other similar assets that are traded on a national exchange (e.g., the New York Stock Exchange or the Chicago Board of Trade). Obviously, the fair market value of these securities is crystal-clear on a day-by-day basis. In this situation, the IRS lets the capital accounts of the LLC's members be periodically updated in accordance with generally accepted accounting principles ("GAAP").
 - f) Admissions of service partners. Finally, the U.S. Treasury Department has recently issued final regulations permitting revaluations of partnership assets upon the admission of service partners – i.e., partners that will be permitted to participate in partnership profits without making contributions to partnership capital. Obviously, the non-service partners will want these revaluations in order to lock in their respective shares of the partnership's value up to the date of the service partner's admission.
- 6) An anomaly under the Capital Account Regulations - sales of LLC interests by the members. Somewhat anomalously, the Capital Account Regulations do not permit revaluations of LLC assets when existing members sell their memberships to other members or to third parties. However, as indicated above, even though the purchaser's capital account may not reflect the economic reality of its value at the moment of purchase, this discrepancy will eventually be eliminated upon the new member's redemption or upon the LLC's own liquidation.
- 7) Why don't C and S corporations have to maintain capital accounts for their shareholders? Upon hearing the above discussion of LLC capital accounts, my LLC formation clients sometimes ask me why LLCs have to maintain capital accounts for their members, whereas corporations (and indeed, LLCs) taxable under Subchapter C or S do not.

The reason is that, not only because of economics but also because of corporate law requirements, all allocations and distributions by state law business corporations, whether they are C or S corporations, must be on a pure per-share basis. Thus, these corporations can never have the kind of temporary disconnect between contributions, allocations and distributions that LLCs can often have. By contrast, LLCs taxable as

partnerships may (as discussed above) allocate their profits, losses and distributions not only on a “per-contribution” or “per-share” basis but also on a “per-contract” basis that provides for “special” allocations and distributions. These special allocations and distributions can only be kept track of with accurate capital accounts, and LLC deals in this situation can only be fair in liquidation situations if these accounts are zeroed out. Per-contribution and per-share allocations of an LLC’s values can be done by simple division. Per-contract allocations, by contrast, requiring painstaking additions to capital accounts and subtractions from them; you can’t do the trick by mere division.

- 8) The primary importance of capital accounts is economic. The above is a brief discussion of the economic reasons for capital accounts. I hope this discussion will make it clear that even if the IRS didn’t require your LLC to maintain a capital account for each of your members, you would want the LLC to do so in order to ensure that the members get the economic deal they bargained for.
- 9) Why does the IRS care about capital accounts? Why, though, should the IRS even *care* about economic justice among the members? After all, the IRS is interested in tax, not economics. The reason for the IRS’s concerns about LLC economics is that, for all the daunting complexity of partnership federal income taxation, the ultimate purpose of partnership tax rules is simple – namely, to ensure that in the end, arm’s-length economics, and not tax, governs partnership allocations and distributions. The way the IRS seeks to enforce this purpose is essentially (i) by requiring partnerships to maintain sound capital accounts for their members; and (ii) by using these accounts as the basis for partner and partnership liquidations.
- 10) Conclusion. When it comes to partnerships, the IRS wants to ensure that no matter what may happen on an interim basis within a partnership (including an LLC taxable as a partnership), in the end, economics will trump tax in the case of each partner (and LLC member). Capital accounts are the IRS’s tools for obtaining this outcome.