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Real Estate Partnership and Joint Venture Agreements: Tax Challenges

Structuring Provisions to Achieve Tax Benefits and Avoid Common Pitfalls

WEDNESDAY, AUGUST 29, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Saba Ashraf, Partner, **McKenna Long & Aldridge,** Atlanta

Allen B. Walburn, Partner, **Allen Matkins**, San Diego

Carey W. Smith, Partner, **Arnold & Porter,** Washington, D.C.

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ARNOLD & PORTER LLP

Real Estate Partnerships and Joint Venture Agreements: Tax Challenges

Part I – Partnership/joint venture formation

Carey Smith
Carey.Smith@aporter.com
202.942.5538
August 29, 2012

Part I Agenda

- Cash capital contributions
- Liabilities
- In-kind capital contributions
- Disguised sales
- Additional capital contributions and dilution provisions

Cash capital contributions

- Simplest possible fact pattern – partner contributes cash to partnership in exchange for a partnership interest
- No recognition of income to contributing partner or to the partnership.
- Partner's initial tax basis for its partnership interest is equal to the amount of cash contributed.
- Partner's holding period begins on date of acquisition of partnership interest.
  - If partner contributes cash on multiple dates, holding period for partnership interest will be calculated separately with respect to each contribution.

Cash capital contributions (continued)

- Example. A is a 50% partner in AB partnership. Each of A and B contributes $100 cash (total of $200) on January 1, 2011 in consideration for their interests. On January 1, 2012, AB requires additional cash in amount of $100, and each of A and B contributes additional $50 cash to AB.
- On September 1, 2012, A sells its entire partnership interest to C for $400 cash. Assuming no intervening allocations or distributions, we know that A's tax basis is $150, so A has taxable gain on the sale of $250 (capital gain, assuming no special rules). Is this long-term or short-term capital gain?
- Answer depends on the value of A's partnership interest as of 1/1/12. A has to bifurcate interest into two pieces, the part held since 1/1/11 which generates long-term capital gain and the part acquired on 1/1/12 which generates short-term capital gain.

Cash capital contributions (continued)

- Partner receives capital account credit equal to the amount of cash contributed. Immediately on the initial formation/contribution of cash, for that moment in time, partner's capital account equals partner's tax basis (and also equals FMV of partnership interest).

Liabilities

- In general, when a liability shifts between a partnership and a partner, that is treated for tax purposes the same as a transfer of cash between those parties.
- So if partner assumes the liability of a partnership, that is treated the same as if the partner had contributed cash to the partnership in the amount of the assumed liability.

Liabilities (continued)

- Usually in real estate context, the liability assumption is moving in the other direction, because a partner is contributing property to a partnership and the partnership is assuming the partner’s liability.
- Alternatively, partnership accepts property that is subject to a liability (such as real property that is subject to a recorded mortgage or deed of trust).
- These are treated generally the same for tax purposes, as a cash distribution from the partnership to a partner.

Liabilities (continued)

- Section 752 establishes detailed rules to allocate a partnership's liabilities among its partners. If a partnership liability is allocated to a partner, that is also generally treated for tax purposes as a contribution of cash by that partner to the partnership. If a partnership liability shifts away from a partner to another partner, or is paid by the partnership, that is generally treated as a distribution of cash by the partnership to the first partner.
- In real estate JVs, there is often significant attention paid to the Section 752 allocation of liabilities.

Liabilities (continued)

- Example. A owns real property having a value of $1,000 and a tax basis of $0, which is subject to a customary non-recourse mortgage loan of $200. A contributes the property to a 50/50 partnership with B, AB partnership, with B contributing $1,000 of cash to be used by AB to improve the property. The mortgage loan will stay in place and be assumed by AB.
- The $200 loan is becoming a partnership liability and has to be allocated between A and B under Section 752. In the absence of other facts, the loan would generally be allocated 50/50, so $100 of the liability is allocated to A and $100 to B. From A's perspective, this will generate $100 of taxable gain (net deemed distribution of $100 in excess of A's basis).
- If A is willing to bear the economic risk of loss for the entire $200 loan, e.g. by guaranteeing the entire loan without right to seek contribution from B, then A would not have any net deemed distribution and thus no immediate taxable gain.

In-kind contributions

- Section 721 provides a basic rule of nonrecognition of gain or loss for a contribution of "property" in exchange for a partnership interest.
- Unlike with corporations under Section 351, there is no "control" requirement.
- The definition of "property" is construed fairly broadly, but it excludes services. Some contributions may be difficult to distinguish between property and services.
  - Example. A spends several months pursuing a real property acquisition, eventually signing a purchase agreement. A assigns the purchase agreement to a new partnership AB, receiving capital account credit of $100 to reflect the FMV of the purchase agreement.
  - This is probably treated properly for tax purposes as a contribution of property and not services, but that is not entirely clear, and there are many factual questions that could change the analysis.

In-kind contributions (continued)

- Real estate sponsors, developers, managers generally do not want to be treated as receiving a “capital interest” in a partnership in exchange for services.
- Any partnership interest can be classified as a “capital interest” or a “profits interest” on the date that it is issued to a partner.
- A “profits interest” is defined as a partnership interest that has a value of zero based on an immediate hypothetical liquidation. If a partner receives solely a profits interest, then on the date interest is issued, that partner’s capital account value is zero. (Profits interest often referred to in non-tax terms as carry, promote, or carried interest.)
- A “capital interest” is anything else (value greater than zero based on immediate hypothetical liquidation).

In-kind contributions (continued)

- A person receiving a capital interest in exchange for an in-kind contribution of services, is taxed immediately on receipt of the interest, based on the fair market value of the partnership interest received. (Under proposed guidance, parties may use immediate-hypothetical-liquidation value as proxy for FMV.) It is rare for taxpayers to voluntarily bargain for this tax treatment.
- A person receiving a profits interest in exchange for an in-kind contribution of services, is **not** taxed immediately on receipt of the interest.

In-kind contributions (continued)

- Back to simpler case – a clear contribution of property to partnership in exchange for a partnership interest.
- Tax basis
  - Partner's initial basis in partnership interest is its basis in the contributed property.
  - Partnership takes a carryover basis in the contributed property.
- Built-in gain (or loss)
  - Often the FMV of contributed property (as negotiated by the contributing and other partners) is not equal to the tax basis of the property. The difference is built-in gain (or loss).
  - Built-in gain (or loss) is addressed under Section 704(c) and extensive regulations thereunder.

In-kind contributions (continued)

- Holding period
  - So long as the contributed property is a capital asset in hands of the contributing partner, that partner will have a "tacked" holding period in its partnership interest – treated as if partner had held the partnership interest for the period beginning on acquisition by partner of the contributed property.
  - Partnership similarly takes a tacked holding period in the contributed property.
- Contributing partner receives capital account credit equal to the FMV of the contributed property

In-kind contributions (continued)

- Focusing on capital accounts – at any given time, a partner's capital account reflects the net value of that partner's interest in the assets of the partnership
- Capital account (as we use that term) does not necessarily reflect:
  - Fair market value
  - Tax basis
  - GAAP accounting
- Some partnerships maintain and report capital accounts on a tax basis; these are not really capital accounts
- For our vocabulary, a capital account has to be maintained in accordance with the Treasury Regulations under Sec. 704(b)

In-kind contributions (continued)

- Basic Capital Account Maintenance
- A partner's capital account is <u>increased</u> by:
  - Money contributed to the partnership
  - The fair market value of property contributed, net of any liabilities
  - Allocations of partnership income and gain
- A partner’s capital account is <u>decreased</u> by:
  - Partnership distributions of money
  - The fair market value of property distributed, net of any liabilities
  - Expenditures that are nondeductible under Section 705(a)(2)(B) or are syndication costs
  - Allocations of partnership deductions and losses

In-kind contributions (continued)

- Best practice is for partnership to maintain capital accounts in accordance with Treasury Regulations
- The defined term "Capital Account" can sometimes be used in JV agreement provisions in ways that are confusing or inaccurate. Need to understand whether capital accounts will always be consistent with the business deal, or whether there can be circumstances where capital accounts are not proportionate to real ownership interests based on the detailed capital account maintenance rules.
- If there is any risk of confusion or inaccuracy, best practice is not to allow the economic provisions (e.g. right to receive distributions) key off of capital accounts.
- Alternatively, if it is important for economic provisions to be driven by the capital accounts, there is a premium on accurate drafting and implementation of provisions relating to allocations and other maintenance of capital accounts.

Disguised sales

- We have been discussing formation of a partnership. Base case is that 2 or more partners come together to form a new entity (partnership or LLC for state law purposes), and each contributes cash, services, and/or other property in exchange for interests in that entity.
- Under that base case, federal income tax treatment matches state law treatment.
- In many cases, particularly in the world of formation of a partnership, the federal income tax treatment is different than the state law treatment.

Disguised sales (continued)

- Many examples of this disconnect result from the fact that a state-law entity (often an LLC) can be disregarded for federal income tax purposes.
  - In the absence of a check-the-box election, an eligible entity such as a domestic LLC is disregarded for federal income tax purposes if it has only one owner.
  - Example. A forms LLC1, contributes cash, services or other property to LLC1 in exchange for 100% of the interests in LLC1. Although this is a "formation" of LLC1 for state law purposes, it is a non-event for federal income tax purposes.
  - Continuing the example. If B later contributes cash, services or other property to LLC1 in exchange for an interest in LLC1 (could be 1% or 50% or anything else), that event causes the formation of a partnership for federal income tax purposes, even though there is no new entity being formed for state law purposes.

Disguised sales (continued)

- The disguised sale rules provide additional examples where a transaction is treated differently for state law purposes (or just in the documents) and for federal income tax purposes.
- General rule – if the disguised sale rules apply, a purported contribution of property may be treated in whole or in part as a sale of the property to the partnership in exchange for the transfer by the partnership to the purported contributor of cash or other consideration.

Disguised sales (continued)

- Example. A and B form AB Partnership. A contributes property X having a value of $500 and tax basis of $300, and B contributes $250 cash. Immediately thereafter, AB distributes $250 cash to A. After these transactions, A and B each have a $250 capital account and a 50% interest in AB.
- If form is respected, A would not have any taxable gain.
- Form will not be respected! A is really contributing half the property and selling the other half. A must allocate its $300 basis between those two halves, and A is treated as contributing a property with $250 FMV and $150 basis, and selling a different property for $250 cash with a $150 basis (recognizing $100 of immediate taxable gain).

Disguised sales (continued)

- Determination of disguised sale is based on all facts and circumstances. The regulations list many factors that may be relevant, but the key factors are:
  - Is there a transfer of property from contributing partner to partnership;
  - Is there a transfer of money or other consideration by the partnership to the contributing partner;
  - Are those 2 transfers related such that the second transfer would not be made but for the first; and is the second transfer dependent on the entrepreneurial risks of partnership operations.

Disguised sales (continued)

- Presumptions under disguised sale rules
  - Transfers made by the partnership more than two years before or after the purported contribution (favorable presumption)
  - Transfers made by the partnership within two years of the purported contribution (unfavorable presumption).
    - Example. Partner A transfers undeveloped unencumbered land with a built-in gain of $500 (FMV of $1,000 and adjusted tax basis of $500) to AB Partnership. AB intends to develop the land by constructing a building on it, and AB's partnership agreement provides that upon completion of construction AB will distribute $900 to A. If within 2 years of A's contributing the building is completed and AB makes a distribution to A pursuant to the partnership agreement, such distribution will be presumed a disguised sale of part of the land by A unless rebutted.

Disguised sales (continued)

- Exceptions to disguised sales. There are several exceptions in the regulations that are specifically **not** treated as disguised sales. Among the more interesting exceptions for planning with real estate joint ventures:
  - Reimbursement of pre-formation capital expenditures
    - Permits transfer by partnership to reimburse partner for capital expenditures (1) incurred during 2-year period prior to property contribution and (2) incurred with respect to the contributed property (or partnership organization and syndication costs)
    - Reimbursement cannot exceed 20% of FMV of the property at the time of contribution. However, that 20% limit does not apply if the FMV of contributed property does not exceed 120% of the partner's tax basis in the contributed property at the time of contribution.

Disguised sales (continued)

- Exceptions to disguised sales (continued).
  - Debt-financed distributions
    - Partnership may transfer proceeds of a partnership liability (i.e. the amount borrowed) to a partner, and this is not treated as a disguised sale if the partner receiving the distribution is allocated 100% of the partnership liability under the liability allocation rules of Section 752.
    - The debt financed distribution exception was the subject of the recent, and heavily criticized, case: Canal Corporation, 135 TC No. 9. In that case, the Tax Court held that the debt-financed distribution exception did not apply, invoked the partnership anti-abuse rule to disregard an indemnity agreement entered into by the recipient of the debt-financed distribution, and held that the recipient did not bear the economic risk of the partnership's liability. The Tax Court further held that a "should" level tax opinion obtained from PwC did not provide the recipient with a good faith and reasonable basis defense against a substantial understatement penalty. For the Court, a key fact was that the provider of the indemnity did not have assets equal in value to the amount of the indemnity.

Additional capital contributions and dilution provisions

- The admission of a new partner or the contribution of additional capital by some but not all existing partners can lead to dilution of the other partners' interests. It can also lead to potential tax issues.
- If a partnership has built-in gain in its property at the time a new partner is admitted, it is generally advisable to “book up” or revalue the original partners’ capital accounts to fair market value. This allows the preadmission appreciation to be allocated solely to the original partners (both economically, and for tax purposes based on Section 704(c) principles)

Additional capital contributions and dilution provisions

- Dilution provisions. If one or more partners fail to contribute required capital contributions, a partnership agreement may call for adjustments in the partners' interests. Often these include "penalty" dilution.
- These provisions sometimes are ambiguous or contradict the allocation or distribution provisions, where the latter provisions assume that percentage interests will not change at any time during the partnership's life. Consider whether there is a need to address changes in capital accounts that will match (or follow) the changes in percentage interests resulting from the dilution provisions.

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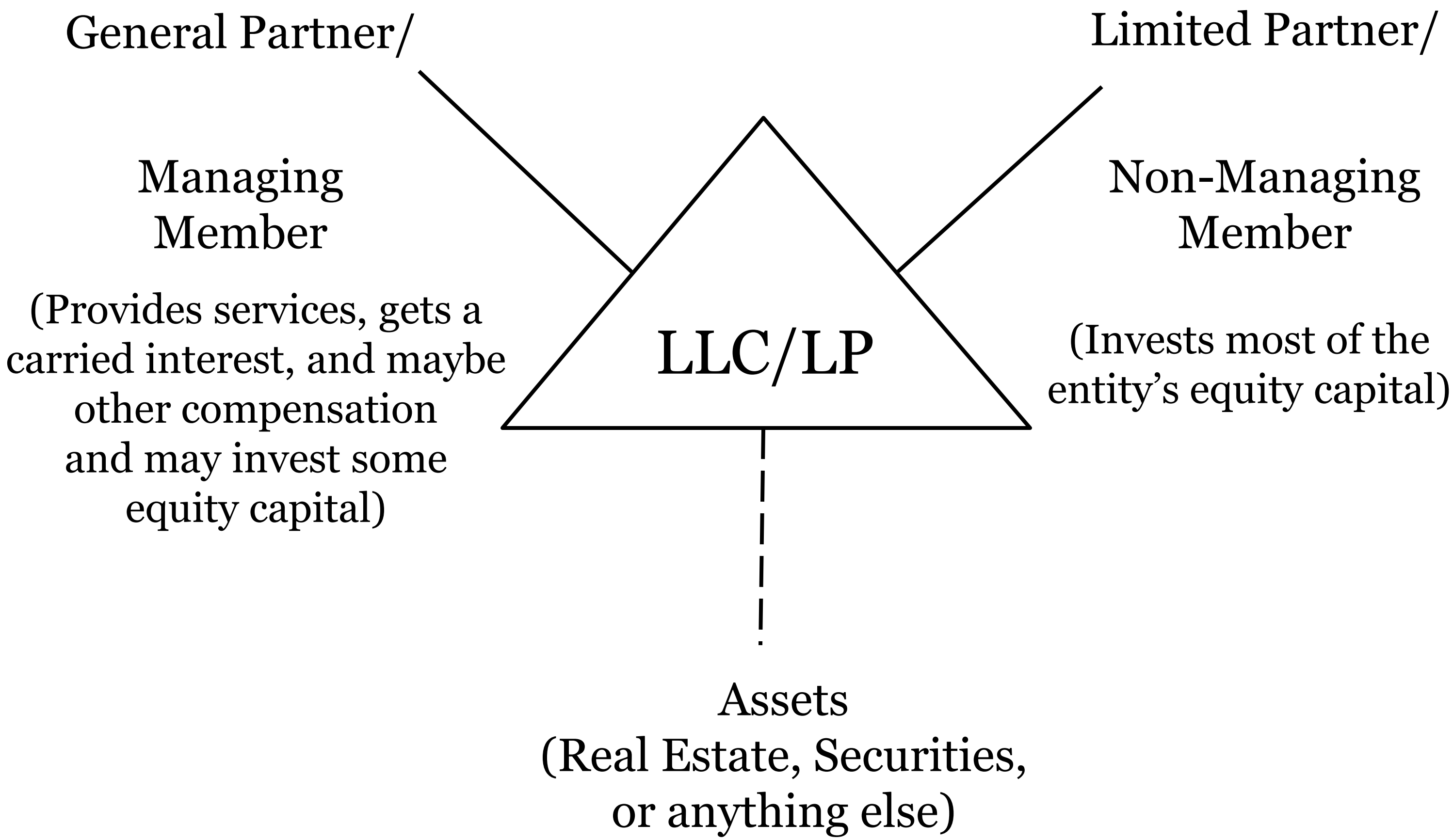
Allen B. Walburn
Allen Matkins Leck Gamble
Mallory & Natsis LLP

619.235.1547
awalburn@allenmatkins.com

Carried Interests

Typical LLC Structure



Carried Interests

- Carried interest = "carry" or "promote."
  - Often used interchangeably with "profits interest."
  - It is a profits interest issued for services; the holder has a greater proportionate interest in profits than the holder's proportionate share of invested capital.
- The holder of a carried interest ("Manager") often participates in a straight *percentage* of the LLC's future profits (for example, 20%), after some specified return to the cash investor.
- In more complicated deals, there can be more than one promote tier (for example, 20% after a specified return to the investor, 30% after a higher specified return is achieved, 40% after an even higher specified return is achieved).
- Manager may put cash (perhaps 1% - 10% of the total equity), but the carried interest is not granted for the cash.

Carried Interests

- Manager reports its distributive share of income, gain, loss, deduction and credit. The character of the Manager's share of the LLC's income, gain, loss, deduction or credit is the same as the character reported by the LLC.
- Thus, if the LLC recognizes long-term capital gain, Manager (or individual owners of the Manager entity if the Manager entity is a pass-through entity for tax purposes) is taxed on its share of the gain at capital gain rates.
- Maximum federal long-term capital gain rate for individuals is generally 15% in 2012, but scheduled to increase to 20% in 2013, plus additional 3.8% Medicare tax on investment income (including capital gain) beginning in 2013.
- By comparison, ordinary income is taxed at a maximum federal rate of 35% (plus 2.9% Medicare tax on self-employment income) scheduled to increase to 39.6% and 3.8% Medicare tax in 2013.

Carried Interests

- Carried interests have been around for many decades, especially in real estate deals.
- Controversy suddenly arose in 2007, largely because of publicity surrounding private equity fund and hedge fund managers' huge capital gains taxed at low rates and lavish spending.
- Anti-carried interest legislative proposals are discussed below.
- Although real estate LLCs are not necessarily the intended target of the proposals, they are likely to be affected.

Receipt of Profits Interest

- Rev Proc 93-27, 1993-2 CB 343, defines two types of partnership interests, as determined at time of issuance:
  - *Capital Interest*: partnership interest that would entitle the holder to a share of liquidation proceeds if partnership assets were sold at FMV, the partnership's liabilities were paid off and the remaining proceeds were distributed to the partners in accordance with the provisions of the partnership agreement. A capital interest is taxable to the recipient upon issuance if its liquidation value exceeds the amount of the recipient's capital contribution.
  - Example: if Manager contributed $1,000 of capital to a partnership but was entitled to $2,000 under the partnership agreement on an immediate hypothetical sale and liquidation, the Manager would have $1,000 of taxable ordinary compensation income on receipt of the excess $1,000 capital interest. This could happen if, for example, the investor contributed $9,000 but the parties agreed to split all distributions including liquidating distributions, 80% to the investor and 20% to the Manager. Solution: liquidating distributions should either be made (i) in accordance with capital account balances or (ii) first to return the members' capital contributions and then 80-20%.
  - *Profits Interest*: partnership interest that is not a capital interest; generally entitles holder only to a share of post-issuance partnership income and gain, but no excess liquidation proceeds upon an immediate hypothetical sale and liquidation. Carried interest is a profits interest.

Receipt of Profits Interest

- IRS will accept that the receipt of a profits interest in exchange for services is not a taxable event for the partnership or the recipient, if:
  - The interest isn't related to a substantially certain and predictable stream of income from partnership assets (e.g., income from a high-quality debt securities or a high-quality net lease).
  - The interest is not disposed of within two years.
  - The interest is not a limited partnership interest in a publicly traded partnership. Not an issue in the typical real estate joint venture.
  - Rev. Proc. 2001-43 addresses unvested profits interests. Is the typical carried interest or promote considered "unvested" under Section 83 if the Manager is required to forfeit all or a portion of the profits interest on the occurrence of certain events, such as resignation, death, disability, removal by the other members, etc.? If so, an 83(b) election should probably be filed.

Drafting Considerations

- Key to tax-free carried interest is that the Manager starts out with zero capital account (or a capital account no higher than the value of cash or other property contributed).
- Manager should be entitled to none of the proceeds with respect to the profits interest if the LLC were to liquidate immediately after the interest is granted.
- If Manager makes a capital contribution and has a profits interest over and above the Manager's proportionate share of contributed capital, does the profits interest portion qualify as a profits interest under Rev. Proc. 93-27?
  - In other words, can the excess profits interest portion of the Manager's LLC interest be separated from the capital interest portion attributable to the Manager's capital contribution? Recall the definition of a "profits interest" under Rev. Proc. 93-27.
  - Should the LLC Agreement expressly bifurcate the Manager's LLC interest into a capital interest and a separate profits interest by designating them as two separate interests? This is not usually done in practice.

2005 Proposals

- Proposed regulations under several Code sections, and accompanying proposed revenue procedure, Notice 2005-43, issued in May 2005. REG-105346-03.
- When effective, they would obsolete current guidance, including Rev Proc 93-27 and Rev Proc 2001-43.
- However, the proposals would generally allow partnerships to achieve the same favorable results as under current guidance, *if* the right elections are made:
  - "Safe harbor" liquidation value election.

FMV or Liquidation Value

- Default rule (no election):
  - Service partner taxable on fair market value of partnership interest.
  - Value of partnership interest is the amount a willing buyer would pay a willing seller.
  - Even a pure profits interest has some fair market value, and is taxable at grant.

FMV or Liquidation Value

- "Safe Harbor" election under Notice 2005-43:
  - Value of partnership interest equals "liquidation value."
  - However, there are requirements to make an election:
    - Partnership agreement must contain provisions, legally binding on *all* of the partners, that *all* partners agree to comply with the safe harbor.
    - Alternative: Each partner in the partnership must execute a legally binding document agreeing to the safe harbor.
    - Effective date of election cannot be prior to execution date.

Final Regulations

- Treasury reportedly is ***not*** working on finalizing the 2005 proposals.
- Treasury is waiting to see what Congress comes up with in carried interest area.
- Some LLC Agreements refer to the 2005 proposals to ensure that they will be able to make the "liquidation value" election if one is ever available.
- Proposed carried interest legislation is discussed below.

Carried Interests: Proposed Legislation

- Several bills have been introduced in Congress to add new "Section 710" to the Code.
- There are differences among the bills but all would:
  - Characterize allocations attributable to many carried interests as ordinary income, subject to:
    - Ordinary income tax rates *plus*,
    - Self-employment tax.
  - Apply to many entities besides private equity funds and hedge funds, including real estate partnerships and LLCs.
  - <u>Deny</u> any compensation deduction to the other LLC members.
  - <u>Continue to permit carried interests</u> to be received free of initial tax, unlike compensatory corporate stock.

Carried Interests: Proposed Legislation

- All versions have some exception for invested capital.
  - To the extent Managers receive a return on their own invested capital, § 710 does not apply.
  - However, the exception has been drafted narrowly.
- Versions have been passed several times by the House but not enacted.
- Latest bill is H.R. 4016, introduced by Senator Levin on February 14, 2012.

What Can Managers Do?

- Techniques that might work under some versions of § 710 are prohibited under others.
- For example, under the more recent proposals, it is very unlikely to help for the Managers to:
  - Borrow from the cash investors to make a bigger capital investment in the LLC.
  - Take convertible or contingent debt, options, or derivatives, with respect to the LLC.
- There have been inaccurate reports that Managers are rushing en masse to restructure their carried interests and amend LLC Agreements.
- Many partnership agreements, particularly for real estate funds, private equity funds and hedge funds, now include provisions allowing the Manager some flexibility to restructure its interest to attempt to retain capital gain treatment as long as there is no adverse effect on the other partners. What about single asset real estate joint ventures?

What *Won't* Section 710 Affect?

- The scope of § 710 – if enacted – is impossible to predict.
- However, although the versions that have passed the House are overbroad, Congress' target has been *investment* managers.
- LLC members active in operating businesses are the *least* likely to be affected, even though they (like recipients of corporate stock) often earn capital gain by performing services.

Carry vs. Phantom Equity

- Phantom equity (employee compensation that is based somehow on the LLC's performance) is not intended to be real equity.
  - The holder is an employee.
  - Distribution, allocation, and contribution provisions of the LLC Agreement are generally irrelevant.
  - The holder never has a capital account and is never a partner in the Partnership under state partnership or LLC law.
  - The holder never has capital gain.

Profit & Loss Allocations

- General Allocations of Profits and Losses
- Special Allocations, Including Depreciation
- Sale or Exchange of Contributed Property

Allocations

- Partnership agreement allocations will be respected by the IRS unless they lack substantial economic effect ("SEF"), or the allocations are not in accordance with partners interests in the Partnership ("PIP") [§704(b)].
  - The regulations on SEF are long and detailed but are premised on one simple fact.
    - A partnership is an economic agreement among its partners and the regulations were written to ensure that the tax consequences are consistent with the economics.
    - In other words, if profits exceed losses over the life of the partnership, the cumulative profits (in excess of losses) allocated to each partner should, over the life of the partnership, equal the amount of distributions received by the partner from the partnership, minus the capital contributions made by the partner to the partnership. If losses exceed profits, the amounts distributed to each partner over the life of the partnership should equal the total capital contributions made by each partner to the partnership, minus the losses (in excess of profits) allocated to the partner. These concepts apply for both the SEF test and the PIP test.

SEF - Two Tests

- #1 – Economic Effect (mechanical test)
  - For the determination and maintenance of the partner’s capital accounts in accordance with the rules of Reg. §1.704-1(b)(2)(iv) [Reg. §1.704-1(b)(2)(iii)(b)(1)].
  - Upon liquidation of the partnership (or liquidation of a partner’s interest) liquidating distributions are required <u>in all cases</u> to be made according to positive capital account balances of the partners [Reg. §1.704-1(b)(2)(ii)(b)(2)].
  - If such partner has a deficit balance in his capital account after liquidation he is unconditionally required to restore it (a deficit restoration obligation or “DRO”) [Reg. §1.704-1(b)(2)(ii)(b)(3)].

SEF - Two Tests

- Since most agreements will not meet the restoration of negative capital accounts provision there is an alternate test for economic effect.
  - Under Reg. §1.704-1(b)(2)(ii)(b)(3), the failure of an agreement to have a DRO will not fail the economic test if:
    - The allocation does not cause or increase a deficit balance in the partner's specially adjusted §704(b) capital account (in excess of any limited dollar amount of a negative capital account the partner is required to restore);
    - The agreement contains a qualified income offset (QIO) provision which requires items of income and gain to be allocated to such partner to eliminate any such deficit that does occur as quickly as possible.

SEF - Two Tests

- #2 – Substantiality under the rules of Reg. §1.704-1(b)(2)(iii), which are failed if:

1. An allocation is shifting under Reg. §1.704-1(b)(2)(iii)(b), which invalidates allocations that do not affect the total amount allocated to each partner in a particular tax year, but do affect the type or character of income allocated to the partners if the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement.
2. An allocation is transitory under Reg. §1.704-1(b)(2)(iii)(c), which invalidates allocations that will be offset in a later tax year if the total tax liability of the partners will be less than if the allocations were not contained in the partnership agreement.

   Exceptions:

   - 5 year rule
   - Value = Basis Rule (great for real estate)
   - Future income is speculative
3. An allocation fails the overall-tax-effect rule of Reg. §1.704-1(b)(2)(iii)(a), which invalidates allocations that reduce the net present value of one or more partner's tax liability while no partner's after tax economic consequences are reduced on a net present value basis.

Allocations and Liquidating Distributions

- In partnership agreements with cash distribution schemes (i.e., the "waterfall") that are more complex than a very simple straight-up pro-rata waterfall, the trend is to draft the partnership agreement so that liquidating distributions are made to the partners in accordance with the general cash flow waterfall or the waterfall for distributions of cash flow from a sale or refinancing of the property, rather than in accordance with the partners' capital account balances.
- Under this liquidating distribution provision, the attorney ensures that the liquidating distributions are consistent with the partners' economic agreement.
- If liquidating distributions are made in accordance with partners' capital account balances rather than in accordance with the waterfall, Profit and loss allocations are typically designed to force the partner capital accounts to match the amounts the partners would receive if the partnership's assets were sold for book value and the proceeds of this hypothetical sale and any other cash assets of the partnership were distributed to the partners in accordance with the waterfall. These allocations generally should satisfy the PIP test. It is possible with capital account based liquidating distributions, especially with complicated waterfalls, that the partners' capital account balances will not match the amounts they should receive under the agreed-upon waterfall.
- This could happen, for example, because of a drafting error in the profit and loss allocation provisions, or due to an error by the accountants in calculating the amounts to be allocated to the partners under the profit/loss allocation provisions.

§704(b) & The Agreement

- Even though there should be no difficulty meeting the SEF requirements (at least the EF portion), explicit language is required – where?
  - Maintenance of Capital Accounts: capital account section
  - Liquidation/According to Positive Balance: liquidation/dissolution section . . . in current agreements most likely cross-referencing the distribution provisions
  - Alternate Test for EF (QIO): allocation section
- Language dealing with the "Substantial" portion of SEF will not show in an agreement as this is determined as a result of an analysis of the overall operation of the agreement

§704(b) & The Agreement: Other Requirements

- SEF is not the only requirement of §704(b) and the Regs that need to be met. There is almost always a separate allocation section dealing with other §704(b) requirements (e.g., allocations of nonrecourse deductions, minimum gain chargeback, qualified income offset)
  - Section heading is usually referred to as either "Special Allocations" or "Regulatory Allocations".
  - Even though almost always listed after the "general" allocation of profits and losses, these allocations actually occur prior to the general allocation.
    - The general allocation provisions almost always start with something similar to, "Subject to Section Y below," with "Y" being the special or regulatory allocation provisions.
    - The special or regulatory allocation provisions usually start with something similar to, "Notwithstanding the provision of Section X," with "X" being the general allocation provisions.

Regulatory Allocation Examples – Partner Minimum Gain Chargeback

- Holder Nonrecourse Debt Minimum Gain Chargeback.

  Holder Nonrecourse Deductions shall be allocated in the manner required by Treasury Regulation §1.704-2(i). Except as otherwise provided in Treasury Regulation §1.704-2(i)(4), if there is a net decrease in Holder Minimum Gain during any Taxable Year, each Holder that has a share of such Holder Minimum Gain shall be specially allocated items of income or gain for such Taxable Year (and, if necessary, subsequent Taxable Years) in an amount equal to that Holder's share of the net decrease in Holder Minimum Gain. Items to be allocated pursuant to this paragraph shall be determined in accordance with Treasury Regulation §1.704-2(i)(4) and §1.704-2(j)(2). This paragraph is intended to comply with the minimum gain chargeback requirements in Treasury Regulation §1.704-2(i)(4) and shall be interpreted consistently therewith.

Regulatory Allocation Examples – Partnership Minimum Gain Chargeback

- Company Minimum Gain Chargeback.

  If there is a net decrease in Company Minimum Gain during any Taxable Year, each Holder shall be specially allocated items of income or gain for such Taxable Year (and, if necessary, subsequent Taxable Years) in an amount equal to such Holder's share of the net decrease in Company Minimum Gain, determined in accordance with Treasury Regulation §1.704-2(g). The items to be so allocated shall be determined in accordance with Treasury Regulations §1.704-2(f)(6) and §1.704-2(j)(2). This paragraph is intended to comply with the minimum gain chargeback requirement in Treasury Regulation §1.704-2(f) and shall be interpreted consistently therewith.

Regulatory Allocation Examples – QIO

- Qualified Income Offset.

  If any Holder unexpectedly receives any adjustments, allocations or distributions described in Treasury Regulation §1.704(1(b)(2)(ii)(d)(4), (5) or (6), items of income and gain shall be specially allocated to such Holder in an amount and manner sufficient to eliminate the adjusted capital account deficit (determined according to Treasury Regulation §1.704-1(b)(2)(ii)(d)) created by such adjustments, allocations or distributions as quickly as possible. This paragraph is intended to comply with the qualified income offset requirement in Treasury Regulation §1.704-1(b)(2)(ii)(d) and shall be interpreted consistently therewith.

Regulatory Allocation Examples – Nonrecourse Deductions

- Nonrecourse Deductions.

  The Company shall take such action as may be requested by Member X such that after the Capital Accounts have been reduced to zero, nonrecourse liabilities are allocated to Member X in a manner that entitles Member X to one hundred percent (100%) of the Nonrecourse Deductions of the Company for any Fiscal Year; provided that such allocation (i) is in accordance with Treasury Regulations §1.752-3, (ii) does not affect distributions to Member Y pursuant to Section 5.2, and (iii) does not otherwise materially adversely affect Member Y (other than Nonrecourse Deductions Member Y would have been allocated in the absence of this Section 5.4(d)). Holder Nonrecourse Deductions for any Fiscal Year shall be specifically allocated to the Member who bears (or is deemed to bear) the economic risk of loss with respect to the Holder Nonrecourse Debt (as defined in Treasury Regulation §1.704-2(b)(4) are attributable in accordance with Treasury Regulation §1.704-2(i)(2).

  - This is an opportunity for special allocation, especially with regard to real estate (depreciation deductions that are nonrecourse). As a general rule partners can agree to share nonrecourse deductions in a manner different than general sharing ratios, unless such allocation fails one of the "substantial" rules. As seen above, this is an example of a nonrecourse deduction provision that provides for a special allocation.

Regulatory Allocation Examples - Tax Allocations

- Except as provided in Section 5.4(h), for federal, state and local income tax purposes, each item of income, gain, loss or deduction shall be allocated among the Holders in the same manner and in the same proportion that the corresponding book items have been allocated among the Holders' respective Capital Accounts.

Regulatory Allocation Examples – §704(c)

- In accordance with Section 704(c) of the Code and the Treasury Regulations thereunder, income, gain, loss and deduction with respect to any property contributed to the capital of the Company shall, solely for tax purposes, be allocated among the Holders so as to take account of any variation between the adjusted basis of such asset for federal income tax purposes and its initial Book Value. Such allocations shall be made using the "traditional" method specified in Treasury Regulations §1.704-3. In the event the Book Value of a Company asset is adjusted pursuant to Treasury Regulation §1.704-1(b)(2)(iv)(f), the allocations of income, gain, loss and deduction with respect to such asset shall take into account any variation between the adjusted basis of such asset for federal income tax purposes and its Book Value in the same manner as under Section 704(c) of the Code, and the Treasury Regulations thereunder. Such allocation shall be made based on the "traditional" method specified in Treasury Regulations §1.704-3.
- Necessary to govern allocations for tax purpose of built-in gain/(loss) assets. From a drafting point of view the language is pretty boilerplate and only changes are if a <u>specified method</u> has been agreed to by the parties (as in the above example).

Section 704(c) Example

- Assume that partner C contributes depreciable real property with a basis of \$400 and a fair market value of \$1,000 to the equal CD partnership and partner D contributes \$1,000 in cash. Assume further that the property has a remaining depreciable life of 5 years.
- The CD Partnership is thus entitled to an annual tax depreciation deduction of \$80 (\$400/5 years = \$80 per year). Under the § 704(b) capital account maintenance rules, however, the property is initially valued at \$1,000 and is depreciated at the rate of \$200 per year. One-half of this "book" depreciation (i.e., \$100) is charged annually to the capital account of D. However, the maximum annual tax depreciation deduction that can be allocated to D is \$80 under the "traditional" method.
- D is only entitled to \$80 of tax depreciation deductions per year, even though D should economically be entitled to \$100 of depreciation deductions since D essentially "purchased" a one-half interest in depreciable property worth \$1,000 (i.e., \$1,000 x D's 50% partnership interest, depreciated over 5 years = \$100 per year).

Section 704(c) Example (continued)

- Under Treasury Regulation § 1.704-3, alternatives to the traditional method include the traditional method with curative allocations and the remedial method, both of which are designed to give the cash contributing partner the full amount of tax depreciation deductions to which it is economically entitled. The specific § 704(c) method to be used by the partnership is often agreed to in the partnership agreement. The general rule under § 704(c) is that tax depreciation deductions follow book depreciation for the cash contributing partners.
- Note: if the CD Partnership had sold the contributed property for $1,000 immediately following its contribution to the partnership, the entire $600 built-in tax gain ("704(c) gain") would be allocated to C but there would be no "book" gain.
- The $600 § 704(c) gain "burns off" over time as depreciation deductions are allocated to the partners under § 704(c).
- Under § 704(c)(1)(B) if the contributed property is distributed by the partnership to a partner other than C within 7 years after its contribution to the partnership, any remaining § 704(c) tax gain will be recognized by C as a result of such distribution. A similar rule applies under § 737 if other property (other than money) is distributed by the partnership to C within 7 years following C's contribution of the Section 704(c) property to the partnership.

Liquidations, Asset Sales, and Interest Sales

August 29, 2012

Saba Ashraf
McKenna Long & Aldridge LLP
sashraf@mckennalong.com

Allocations and Distributions

- An LLC distribution is an amount that the LLC member receives.
- An LLC allocation is an amount of profits, losses, or other items that are attributed to the member on the LLC's books.
- Typically -- although there are many exceptions -- the distribution is tax-free and the allocation is taxable.
  - The allocation is taxable whether or not there is a corresponding distribution.
  - It may seem exactly backwards that you can receive distributions tax- free but must pay tax on accounting entries. However, for holders of LLC equity interests, that is the normal pattern.
- Contributions, distributions, and allocations are interrelated concepts.
  - Over the life of the LLC, contributions plus or minus allocations equal distributions.
  - Any time you change one of these items – contributions, distributions, and allocations – you must consider how the others may be affected.

Drafting for Liquidating Distributions

- Traditional (layer-cake) allocation.
  - ***Specifies the allocation*** of income and loss.
  - **Liquidating distributions are made so as to match allocations.**
    - More precisely, the distributions are made in accordance with the capital accounts, which in turn reflect the allocations (and contributions, and prior distributions) that have been made.
  - Considered the safer approach under the tax regulations
  - However, may give the members less certainty about the way liquidating distributions will be made.

Drafting for Liquidating Distributions

- Targeted (forced) allocation.
  - ***Specifies the distribution*** of proceeds on liquidation of the LLC.
  - **Allocations are made so as to match liquidating distributions.**
    - More precisely, allocations are made so that capital accounts (subject to some adjustment) equal the amounts that would be distributed if the LLC sold all its assets at the values reflected in the capital accounts and distributed the proceeds to the members in a liquidation.
- Validity of approach under tax regulations is less clear.
  - However, it is intended to produce the same tax results as traditional allocations.
  - It is now widely used, in part because it seems to give the members more certainty about the way liquidating distributions will be made.
  - This approach requires special care when dealing with carried interests issued at different times.

Simplified Examples

- **Traditional Allocations:**
  - Allocate profits to offset prior losses.
  - Allocate all remaining profits pro rata by unit.
  - Allocate losses in accordance with capital accounts.
  - Liquidating distributions made in accordance with capital account.

- **Targeted Allocations:**
  - Allocate profits and losses so that capital accounts (plus required capital contributions and "minimum gain") equal the amounts that the member would receive if the LLC sold all its assets at "book value" (i.e., the values reflected in the capital accounts) and distributed the proceeds to the members.
  - Liquidating distributions made in a specified order of priorities, without reference to capital accounts.

Which Method to Use?

- The debate rages.
- The trend is for more LLC Agreements to use targeted allocations.
- **One exception:** If the transaction needs to comply with the “fractions rule” (Code § 514(c)(9)), targeted allocations are generally not used.
- Fractions rule can be important when the LLC has:
  - Debt-financed real estate.
  - A “qualified organization” as one of the members.
    - Qualified organizations generally include schools and pension plans.
    - Many tax-exempt charities are not “qualified organizations” for this purpose.

Selling a Partnership Business

- Two primary choices:
  - Sale of assets followed by liquidation
  - Sale of partnership interests
- While the tax consequences of an asset sale versus an interest sale aren’t as strikingly different as they are in the case of a corporation, there can still be important differences in the case of sales of partnerships

Similarities in Results Under 2 Primary Alternatives: Character of Gain or Loss

- Long-term capital gains rate: currently, 15%; in 2013, will go to 20% + a new additional 3.8% will apply to net investment income (includes gains from the sale of property, dividends, interest, royalties, rents and other investment income) of those taxpayers with adjusted gross .
- The 3.8% tax does not apply to capital gains, dividends, interest, royalties, rents and other investment income that is derived from a trade or business in which the taxpayer is a not a passive investor. In other words, capital gains, dividends, interest, royalties, rents and other investment income derived from a trade or business in which the taxpayer materially participates (i.e. generally is involved in the operations of the activity on a basis which is regular, continuous and substantial) are not subject to the tax increase.
- The new 3.8% tax applies to investment income that passes through to the partners of a partnership.

Similarities in Results Under 2 Primary Alternatives: Character of Gain or Loss

- Sale of partnership assets: Generally, the operating assets of a partnership that are used in its trade or business and have been held for over a year are Section 1231 assets, whose sale generates capital gain. To the extent that the Section 1231 assets are depreciable, they are subject to depreciation recapture rules of Section 1245 and Section 1250 that can upon sale, convert capital gain to ordinary income.
  - Section 1245 unrecaptured gain taxed at ordinary income rates.
  - Section 1250 unrecaptured gain taxed at 25% rate.

Similarities in Results Under 2 Primary Alternatives: Character of Gain or Loss

- Sale of partnership interests: Under Section 751, the amount of consideration received in exchange for all or partner of a partnership interest that is attributable to the partner's interest in certain partnership assets is treated as proceeds from the sale or exchange of property other than capital assets. These assets include depreciation recapture.
- Thus, the higher 25% cannot be avoided by selling partnership interests as opposed to assets.

Similarities Under 2 Primary Alternatives: Amount Realized Includes Liabilities

- Amount realized from a sale of assets includes the amount of liabilities from which the seller is discharged as a result of the sale (including liabilities the buyer either assumes or takes the property subject to the liabilities).
- Where the interest in a partnership is sold, the partner's share of the debt of the partnership is taken into account in determining the amount of consideration s/he is deemed to received. If a partnership interest is sold, the reduction in the transferor partner's share of partnership liabilities is treated as amount realized.

Similarities in Results Under 2 Primary Alternatives: Basis to Purchaser

- When a buyer purchases assets, the buyer of course gets a stepped up tax basis in the assets of the partnership.
- When a buyer purchases all the interests of a partnership, the buyer is treated as having purchased the assets of the partnership for federal income tax purposes, and thus gets a stepped up tax basis in the assets.

Possible Differences Under 2 Primary Alternatives: Holding Periods

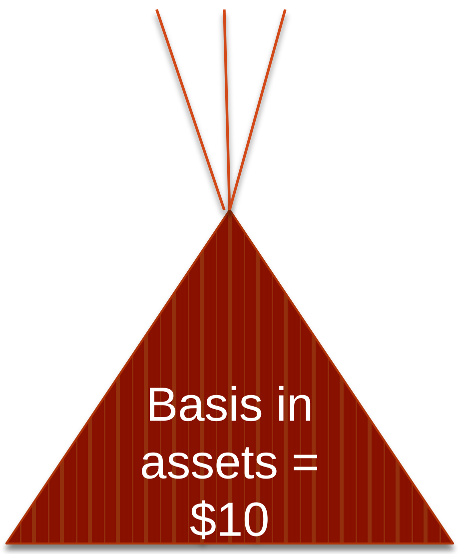
- There may be a difference in tax rate applicable where the holding period for the partnership assets is different from the holding period for partnership interests.
- If assets have been held for less than 12 months, their sale will generate short-term capital gains – subject to a high rate. If the interests have been held for over 12 months, the gain generated will be long-term capital gain (subject to the recapture under Section 751).

Possible Differences Under 2 Primary Alternatives: Difference in Inside/Outside Basis

- Where partner's outside basis is high, a sale of the interest for an amount higher than the basis would generally result in capital gain.
- However, where the partnership has a lower basis in the assets, there can be anomalous results. Here, a sale of the assets will generally result in a Section 1231 gain (assuming the assets are Section 1231 assets) which is significantly higher than the capital gain on the sale of the partnership interests. Upon the distribution of the sales proceeds in liquidation, there would be a capital loss. If the partnership liquidation and the asset sale are in different year, then the capital loss cannot offset the Section 1231 gain.

Possible Differences Under 2 Primary Alternatives: Difference in Inside/Outside Basis

Partners' aggregate basis in partnership interests = $90



-Suppose partners sell interest for $100. There would be capital gain of $10.

-Now suppose assets are sold for $100, and in following year there is a liquidating distribution of $100. This means in year 1, there is $90 of Section 1231 gain taxed as long-term capital gain. As a result of the gain, the partner's basis in their partnership interests goes from $9-0 to $190. On the liquidating distribution, there is thus $90 of capital loss. The capital loss cannot offset the gain in the previous year.

-Even worse, suppose the assets were ordinary income producing assets. Now, even if the asset sale and the liquidation are in the same year, the income will be ordinary but the loss capital, so that it cannot offset the income.

Possible Differences Under 2 Primary Alternatives: Difference in Character of Loss

- A sale of a partnership interest at a loss will generally generate a capital loss.
- As sale of Section 1231 assets at a loss will generally generate ordinary income.
    - However, keep in mind that if a taxpayer has a Section 1231 gain, but has had Section 1231 losses in the past 5 taxable years, the Section 1231 gain is converted to ordinary gain. Section 1231(c).

Possible Differences Under 2 Primary Alternatives: Interests For Services

- Under Rev. Proc. 93-27, Rev. and Notice 2005-43, to fall within the safe harbor that says that the receipt of a profits interest in a partnership in exchange for services is tax-free, one of the requirements that has to be met is that the partnership interest may not be sold within 2 years of its receipt.
- There is no mention of a sale of assets within 2 years of the receipt of the interest.

Possible Differences Under 2 Primary Alternatives: State Taxes

- Generally, the gain from the sale of a partnership interest is sources for state tax purposes to the state of the selling partner's residence or commercial domicile.
- Generally, if assets are sold, the gain is sourced to the state in which the property is located.
- Accordingly, if the assets of the partnership are located in a state with a high income tax, but some or all of the partners are residents of a state with a lower or no income tax, then it may be more tax advantageous to sell the partnership interests rather than assets.
- Note, whoever that some states may treat the sale of partnership interests as the sale of the partnership assets for income tax purposes.
- Also, note that generally, state sales tax does not apply to the sale of intangibles, but does to the sale of tangible assets. Again, note that some states may impose the sales tax on a sale of the entity.

Capital Gains Rate?

- What is the tax rate on the sale of an LLC interest?
- Special rules for determining when:
  - Gain is ordinary income (Code § 751).
  - Holding period is short term (Treas. Reg. § 1.1223-3).
- Long-term capital gain on the sale of LLC interests is ***not*** automatically eligible for the 15% rate, which is ***generally*** the maximum long-term individual capital gain rate.

Transfer of LLC "Units"

- A term like LLC "units" is often convenient as a way to speak about and keep track of transfers of LLC interest.
- However, the division of LLC interests into "units" is essentially meaningless for tax purposes.
- LLC units do not behave like shares of corporate stock; LLC units of the same "class" may or may not be fungible.
- In drafting LLC Agreements, do not assume that "unit" has any meaning other than the meaning it is given in the agreement itself.
  - Important differences among the members may exist even when all members have one "class" of "units."
  - Focus on the full package of rights and obligations that a member has under the LLC Agreement, rather than narrowly on "units."

Additional Transfer Restrictions

- LLC Agreements sometimes single out certain transfers that pose particular tax risks, and
  - Prohibit them entirely, or
  - Impose tighter restrictions on them.
- Some transfer restrictions are designed to ensure that the interests do not inadvertently become “publicly traded,” causing the LLC to be classified as a corporation for tax purposes under Code § 7701(a).
- Some transfer restrictions are designed to avoid “technical terminations” under Code § 708(b)(1)(B).

Additional Transfer Restrictions

5.5 <u>Additional Transfer Restrictions.</u>

5.5.1. <u>Preserve Partnership Tax Status.</u> No Member shall be permitted to transfer any portion of its interest in the Company or take any other action that, in the judgment of the Managers, would materially increase the risk that the Company would be treated as a "publicly traded partnership" within the meaning of Code Section 7704 or be classified as a corporation within the meaning of Code Section 7701(a).

5.5.2. <u>Technical Tax Terminations.</u> No Member shall be permitted to transfer all or any portion of its interest in the Company or to take any other action that would result in a termination of the Company within the meaning of Section 708(b)(1)(B) of the Code, without the approval of the Managers.

Termination of Partnership

- Under the Internal Revenue Code, a termination of a partnership results from two and only two events:
  - *"Actual Termination":* The business ceases to be carried on by the partners in a partnership. If only one partner is left, the partnership has "actually" terminated.
  - *"Technical Termination":* Within a 12-month period, there is a sale or exchange (not redemption) of 50% or more of the total interests in partnership capital and profits.

Technical Termination

- If a partnership terminates by reason of a sale or exchange of an interest, the partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership.
- The terminated partnership is then deemed to make a liquidating distribution of partnership interests in the new partnership to its partners (including the purchasing partner) in proportion to their respective interests.

Technical Termination

- A technical termination is not **necessarily** detrimental. It depends on the facts.
- As a result of 1997 regulations, the biggest problem now tends to be the restart of depreciable lives.
  - Generally, the depreciable lives for partnership real estate and other tangible property begin all over again, so that the depreciation deductions available to the partners are slowed down.
  - An LLC with little depreciable property (such as a real estate development entity) may not care much about technical terminations.

Technical Termination

- *Tax year*:
- The tax year of the partnership ends on the date of its termination.
- If some of the partners don't have the same tax year as the partnership, this early termination can cause a bunching of income.

- *Partnership elections:*
  - Elections made by the terminated partnership are not applicable to the reconstituted partnership.
  - The reconstituted partnership is free to make new elections regarding accounting methods and other matters.
  - The ability to escape unfortunate elections made by the terminated partnership may be a benefit.

Avoiding Technical Termination

- Selling partner might sell ***almost*** 50% of capital and profits, but hold on to a de minimis portion for a year and a day.
- Selling partner might dispose of interest in a transaction that is not considered a "sale or exchange."
  - Redemption by the partnership is not a sale or exchange.
  - If the money for the redemption is coming from the incoming partner, the IRS might try to characterize it as a "disguised sale."

Mid-Year Ownership Changes

- There are two basic methods for allocating income/loss for a year when ownership of the LLC changes during the year.
  - Pro rata by day. Assumes that the LLC has the same amount of profit or loss on each day of the year, even including days after the member's interest has been eliminated.
  - Closing of the books, which tends to be more accurate but requires more effort.
- Hybrid methods may be possible
  - For example, use the pro rata method in general, but closing of the books methods for extraordinary items.

Drafting for Ownership Changes

- The LLC Agreement might:
  - Designate a specific method to be used by all the members.
  - Delegate to a managing partner or manager the authority to choose a method.
  - Allow the method to be chosen by agreement at the time the new member is admitted, with a default rule to be used only if no method is agreed on at the time.

Drafting for Ownership Changes

- **Amendment to LLC Agreement?**
  - LLC Agreements may state that admission or withdrawal of a member does not require an amendment.
  - However, depending on the terms of the admission or withdrawal, an amendment may be necessary anyway.
    - Sometimes the relevant terms of a new transfer, capital or redemption can be set forth through an amendment to the LLC Agreement.
    - Sometimes a separate agreement is needed or advisable.
    - Often all Members, including the transferee, sign an "Amended and Restated LLC Agreement."

Tax Provisions for Transfers

3.1 Capital Account. Effective on the Effective Date, the capital account of the Transferring Member will be transferred to the Transferee.

3.2 Allocations. Based on an interim closing of the books as of the end of the day immediately preceding the Effective Date, Profits, Losses, and all other items of income, gain, loss, deduction, or credit, allocable to the Interest under the LLC Agreement, shall be credited or charged, as the case may be, to the Transferee and not to the Transferring Member.

3.3 Distributions. The Transferee shall be entitled to all distributions with respect to the Interest made on or after the Effective Date, regardless of the source of those distributions.

Tax Provisions for Transfers

9.2 Cooperation on Tax Matters. The Transferee shall provide notification to the Company of the information required by Treas. Reg. § 1.743-1(k)(2)(i), in the form of Exhibit B attached hereto. Notwithstanding any other provision of this Agreement, the Transferring Member shall have the right to receive information in connection with the Company's tax returns necessary for it to protect its interest and comply with law and regulations, including such information as may be required to prepare the statement described in Treas. Reg. § 1.751-1(a)(3). In addition, the parties shall cooperate fully in connection with any audit, litigation, or other proceeding with respect to taxes, with respect to the Company or with respect to the interest of the members in the Company.

Ancillary Agreements

- In transactions that are complex, a separate agreement may be necessary in order to keep the new (or amended) LLC Agreement "uncluttered" on a going forward basis.
- A purchase and sale agreement is appropriate when the seller is the interest holder.
- A contribution agreement is appropriate when the interest is being acquired directly from the company.
- A contribution agreement for a piece real estate looks very much like a sale agreement and not like an LLC Agreement, but check to see that the contribution agreement and the LLC Agreement are consistent with each other.

Tax Treatment of Redemptions

Sometimes the LLC Agreement will spell out the tax characterization of redemptions, for example:

> 7.2 The Redeemed Member hereby acknowledges and agrees that the Purchase Price shall be treated as paid for the Redeemed Member's interest in Company property under IRC § 736(b)(1) only to the extent of the Fair Market Value thereof. The balance of the Purchase Price, including (without limitation) interest or any promissory note given in partial payment of the Purchase Price, shall be treated as guaranteed payments described in IRC § 736(a)(2).

Change in Number of Members

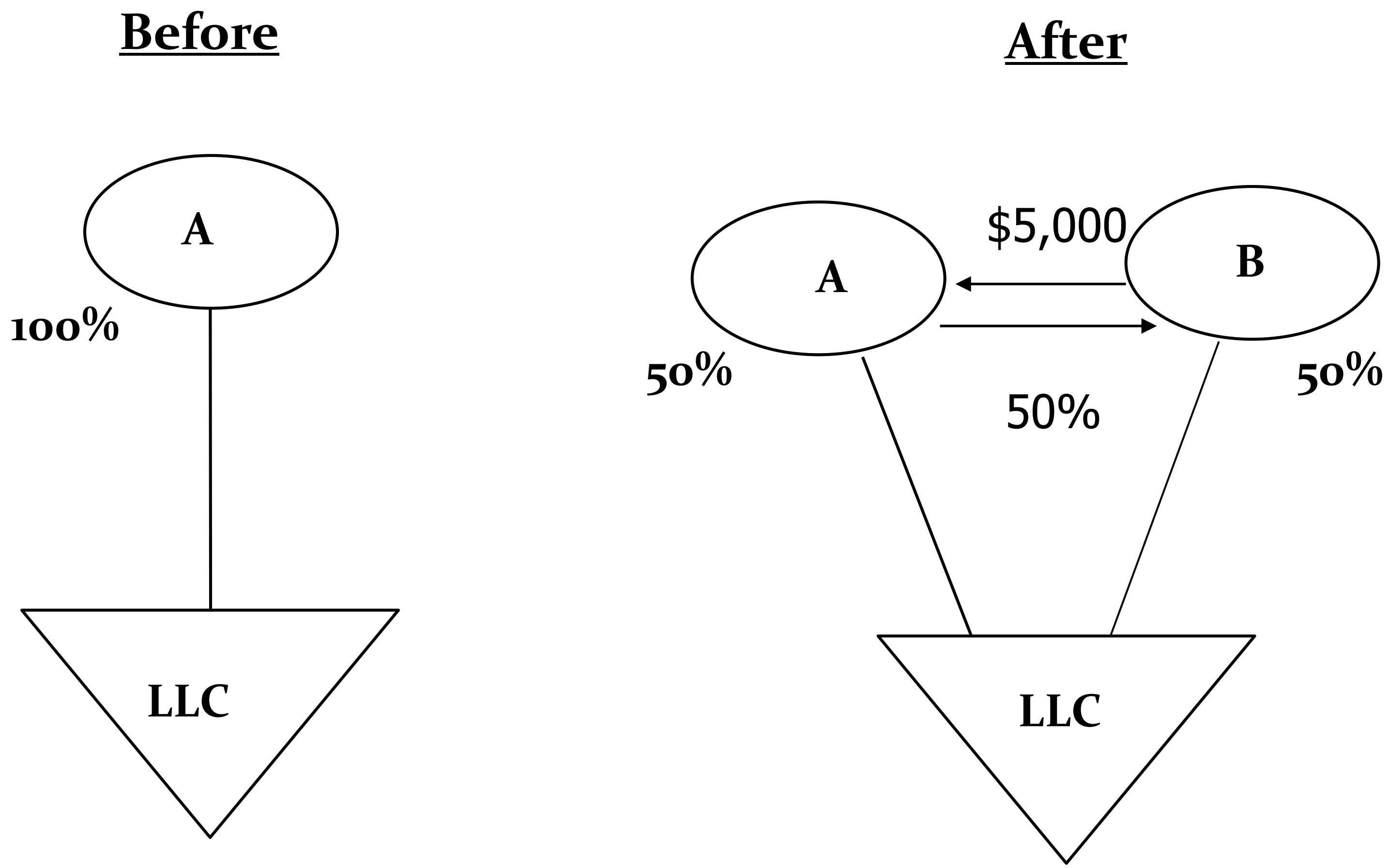
- ***Disregarded Entity to Partnership:*** A partnership becomes a disregarded entity when the entity's membership is reduced to one member.
- ***Partnership to Disregarded Entity:*** A disregarded entity becomes classified as a partnership when the entity has more than one member.

Single-Member LLC Agreements

- An LLC Agreement for a single-member LLC differs radically from a multi-member LLC Agreement.
  - One big difference: a single-member LLC is not taxed as a partnership, so all provisions relating to partnership tax are incorrect or irrelevant.
  - Never start with a model single-member LLC Agreement when drafting for a multi-member LLC, or vice versa.
- If an LLC changes from multi-member to single-member, or vice versa, the LLC Agreement should be completely rethought.

Disregarded Entity to Partnership

Rev. Rul. 99-5 / Situation 1

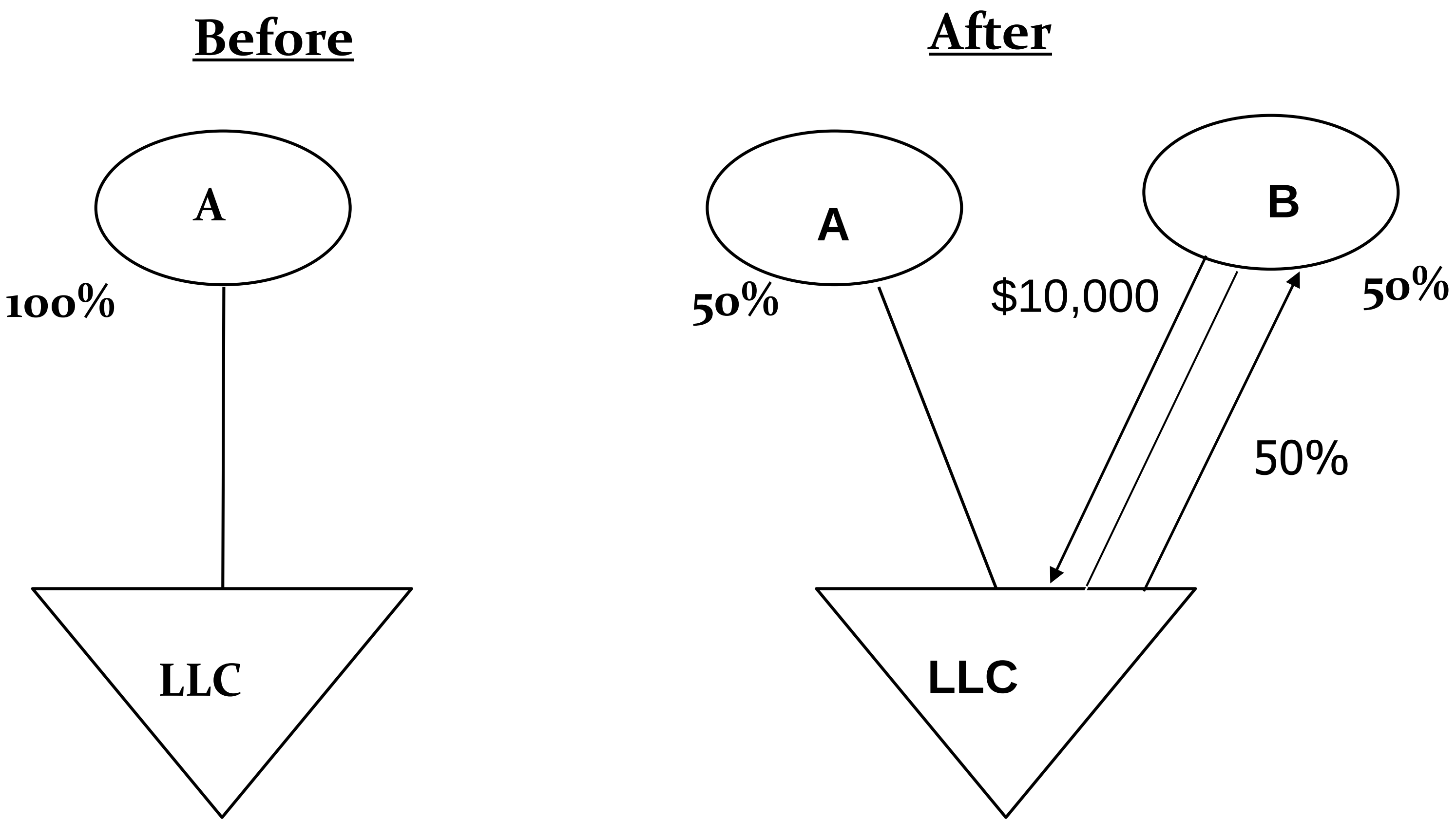


Disregarded Entity to Partnership

- B′s purchase of fifty percent of A′s ownership interest in the LLC is treated as the taxable sale by A of a fifty percent interest in each of the LLC′s assets -- assets which previously had been treated as held directly by A for tax purposes.
- A and B are treated as then contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

Disregarded Entity to Partnership

Rev. Rul. 99-5 / Situation 2

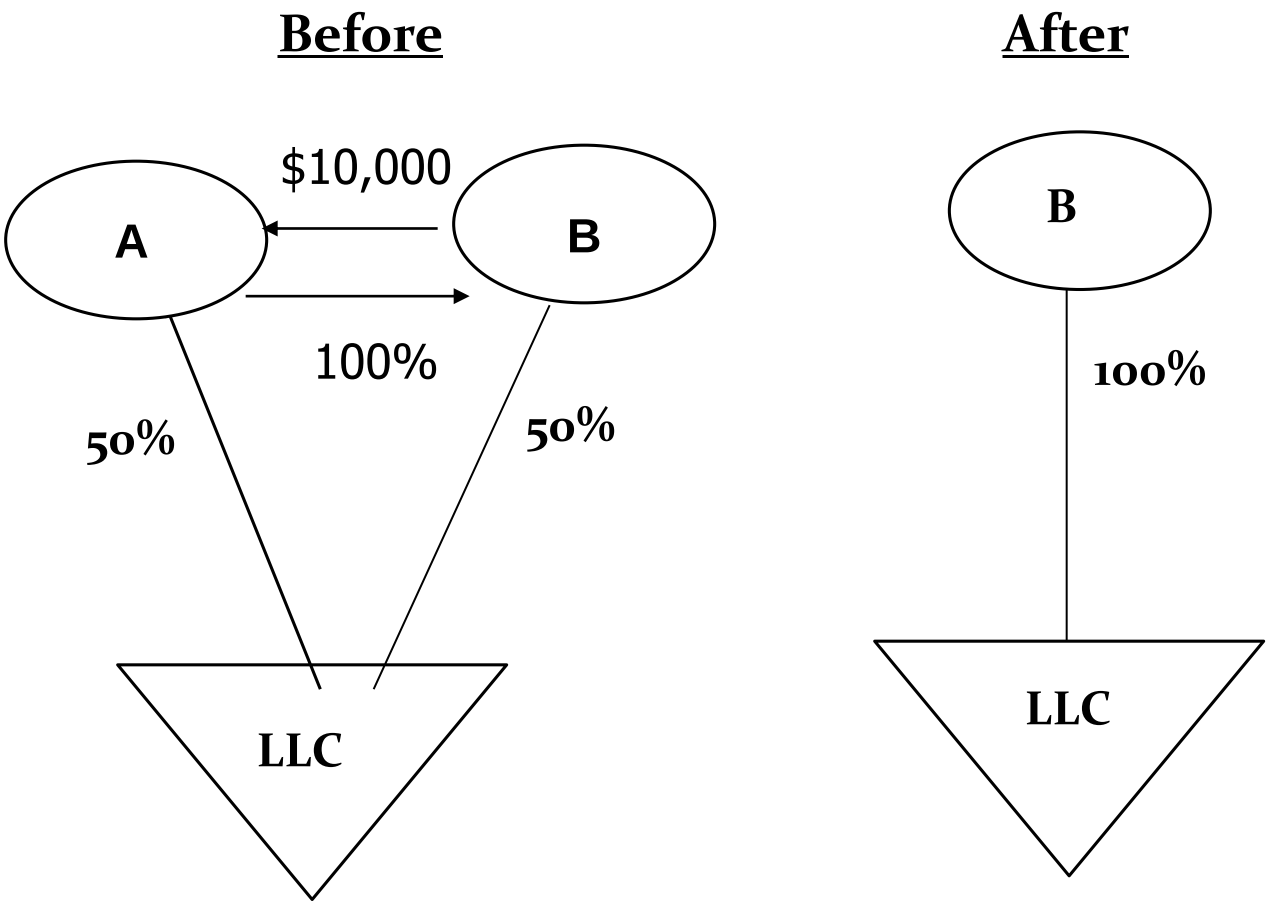


Disregarded Entity to Partnership

- B is treated as contributing $10,000 to a partnership in exchange for a partnership interest.
- A is treated as contributing all of the assets of the LLC to the partnership in exchange for a partnership interest.
- Neither A nor B recognizes any gain or loss on the deemed contributions.

Partnership to Disregarded Entity

Rev. Rul. 99-6 / Situation 1



Partnership to Disregarded Entity

- IRS's position is strange and confusing.
- A is treated as ***selling*** a partnership interest.
- B is ***not treated as purchasing*** a partnership interest.
  - B is treated as purchasing half the partnership's assets from A, with a new holding period.
  - B is treated as receiving half the partnership's assets in a liquidating distribution from the partnership, with a "tacked" holding period.

Partnership to Disregarded Entity

Rev. Rul. 99-6 / Situation 2