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Beware the Taxable Capital Shift

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Over the last decade or so, limited liability companies (LLCs) have become the entity of choice for many business ventures for a number of reasons, including ease and expense of creation, complete limitation on liability for its members, tremendous flexibility from an economic perspective (especially when compared to the rigorous limitations of an S corporation), and favorable income tax treatment.

For tax purposes, an LLC having more than one member is generally classified as a partnership, and as a partnership the LLC itself does not pay federal income tax. Instead, after the end of each taxable year each member of the LLC is given a Form K-1 (K-1) reporting his or her share of the LLC's income, gain, loss and deduction for the year. Those items are then reported on the member's individual tax return.

In some cases, however, the members' tax consequences from an LLC investment (or investment in any other entity treated as a partnership for tax purposes) is not perfectly reflected on a K-1. Certain events can result in a "capital shift" that may result in additional taxable income for a member. These taxable "capital shift" transactions are not always obvious, and great care should be used to ensure that an unwanted "capital shift" does not occur.

Example 1 – Grant of Capital Interest to Service Provider

The simplest and most common form of capital shift occurs in a compensatory situation, and is best demonstrated by the following example. Suppose A and B are members of AB LLC (classified as a partnership for tax purposes), which operates a successful business worth $1,000,000. Suppose further that A and B want to reward and incentivize C, a long-time employee of AB LLC, because she has performed very well historically and has contributed significantly to the growth of the business. To do so, A and B decide to grant C a 10% capital interest in AB LLC. Upon grant, C has a right to a share of LLC capital equal to $100,000. As a result, C has recognized taxable ordinary income of $100,000, even though she in fact received no cash.

Applicable tax rules provide that if a service provider is granted an interest in LLC capital as compensation for past or future services, the fair market value of that interest in LLC *capital* transferred is includible in the service provider's taxable income, either at the time the transfer is made for past services or at the time the services have been rendered where the transfer is conditioned on the completion of the transferee's future services. It is important to note that taxable income is recognized even though no cash is received, and that the income is ordinary in nature.

Example 2 – Grant of Profits Interest to Service Provider

The scenario in Example 1, which can result in current taxation to the service provider, should be contrasted to the grant of a profits interest to a service provider. In a profits interest grant, C is granted a 10% interest in future AB LLC *profits*, but has no right to any part of the $1,000,000 of value that existed before she received her interest. In that case, C should recognize no current taxable income as a result of the grant. The key distinction between the two examples is that in Example 1, if the LLC were to liquidate the day following the grant, C would have an immediate right to receive $100,000 in partnership capital, whereas in this Example C would receive $0 in a next-day liquidation. This "liquidation value" concept is important to consider in the next example.

Example 3 – Preferred Interest Holder

Suppose A and B each contribute $100 to a new LLC (classified as a partnership for tax purposes), which buys property for $200. A receives Class A shares that entitle him to a priority return of capital and a 10% annual cumulative preferred return on capital. B receives Class B shares that entitle him to a return of capital following the distributions required to be made to A. Any remaining profits are split 30 percent/70 percent between A and B, respectively. At the end of Year 1 of the LLC, the value of the property has not changed, and there has been no net income, net loss, or distributable cash. As a result, A's preferred return is not paid and A is not allocated any income from the LLC. Nevertheless, the IRS may argue that A should recognize taxable income of $10 for Year 1.

The argument for current taxation is as follows: at the end of Year 1, the value of the LLC is $200, and A and B's respective shares of that value is determined by the distribution waterfall. Applying the liquidation value concept detailed above, upon liquidation of the LLC at the end of Year 1, A would receive $110 and B would receive $90. Thus, it is arguable that there has been a capital shift between A and B, even though no money has changed hands and no income or loss allocations have been made. In other words, why should A not be taxed the same as C in Example 1?

The case for taxing A is strengthened by tax rules that treat a partner as recognizing ordinary income to the extent of any payment made or otherwise due to a partner for "the use of capital," if such payment is obligated to be made without regard to the partnership's income. This is known in tax parlance as a "guaranteed payment." Here, A's preferred return may be considered to be a guaranteed payment because A gets a 10% preferred return on invested capital even if the LLC never makes a profit. The tax consequences of this guaranteed payment may depend on the LLC's method of tax accounting; if the LLC is an accrual basis taxpayer, the LLC would accrue a current liability reflecting its obligation to make the payment to A. This accrual would permit the LLC to take a current tax deduction (which would be allocated solely to B), but also result in current income to A. If, on the other hand, the LLC is a cash basis taxpayer, the deduction and corresponding income should not be recognized until the payment is actually made.

In my view, A's situation in Example 3 is different from C's situation in Example 1 and should not result in current taxation to A, even if the LLC is an accrual basis taxpayer. Under applicable rules, the change in liquidation preference between A and B after Year 1 generally does not result in a shift in capital account balances on the LLC's books, whereas it does so with C in Example 1. Moreover, I know of no guidance from the IRS – published or otherwise – that would treat A as receiving current income in this situation. Nevertheless, there is a risk that the IRS could take an aggressive position and argue for current taxation.

In summary, appropriate tax planning should be done in any deal involving an LLC to ensure that the desired tax treatment is achieved. For more on capital shifts, see my upcoming article, "*Taxation of Noncompensatory Capital Shifts*," scheduled to be published in the December 5, 2011 issue of Tax Notes.

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