

What Does That Operating Agreement Mean? A Primer on LLC Capital Accounting for the Non-Specialist

By Donald H. Baker, Jr.

Introduction

With the widespread adoption of the limited liability company as a preferred entity format for non-public entities, business practitioners are forced to grapple with provisions in operating agreements that adopt detailed accounting and tax treatments generally beyond the traditional expertise of non-tax lawyers. These accounting and tax issues are not present in forming a standard corporation, but are thrust on the practitioner any time even the most basic multi-member LLC is formed. While the “standard” LLC operating agreement approaches to these matters are at this point generally familiar (though perhaps less well understood), they are not simply “boilerplate.” I fear that we (and of course our clients) are often insufficiently aware that these provisions mandate specific economic relationships and results among the members, i.e., who gets what money. It is entirely possible that use of these standard approaches can unknowingly mandate results that are inconsistent with the client’s business “deal.”

I should note at the outset that this is not intended to explain comprehensively how the “special language” in operating agreements works as relates to profits and loss allocations for tax purposes. These subjects are well beyond what can reasonably be treated in a brief article. Instead, my goal is to explain and simplify, for the non-specialist, the operation of the capital accounting provisions found in the typical operating agreement. Although some of the related tax allocation provisions are surveyed in a cursory way, my focus here is economic – making sure that the parties have a clear idea of the economic impact that their choice of the “typical” language found in an operating agreement has on their business arrangements with other members, in hopes of avoiding unintended consequences.

What is Capital Accounting and How Does It Work?

Practitioners involved in forming limited liability companies are no doubt familiar with language often found in operating agreements mandating that “capital accounts be established and maintained for each member.” Normally this language comes along with detailed rules about how such an account is to be maintained and adjusted over time. Taken together, these rules generally describe “capital accounting” as an accounting method.

Capital accounting is a system of *financial* accounting for general and limited partnerships, and sometimes LLCs, that keeps a record of each member’s *equity* financial interactions with the company on a member-by-member basis.¹ Each member has a separate equity or “capital” account that keeps track of these interactions. The sum of all of the members’ capital accounts equals (as a mathematical certainty) the total member equity shown on the balance sheet of the company (which in turn equals assets minus liabilities). Since capital accounts are maintained on a partner-by-partner (or member-by-member) basis, it is entirely possible that the entity may have positive members’ equity, but some members have a positive capital account and others have negative capital accounts. This disaggregation feature contrasts sharply with an entity approach to equity accounting used in corporate accounting (even in S corporations), where equity transactions are tracked only in the aggregate, rather than on a member-by-member basis, and is the key characteristic of capital accounting as a method.

Capital accounting, as a financial accounting method, is the traditional form of equity accounting used by partnerships and limited partnerships and can be said, for these particular entities, to form part of the body

of accounting practice known as “generally accepted accounting principles” (“GAAP”). However, capital accounting is *not* mandated for limited liability company use, either by GAAP or the Michigan Limited Liability Company Act. Indeed, for limited liability companies, which are something of a statutory hybrid between corporations and limited partnerships, capital accounting *must* be adopted in the operating agreement if it is to have an economic effect on the member’s relations with one another that trumps certain statutory default provisions that would dictate different results. Under the LLC Act, it is clear that the members are free to adopt many methods of economic allocation (and, therefore, accounting for their dealings among the members), so long as the allocation is expressed in an operating agreement.

Many practitioners have the mistaken impression that capital accounting is mandatory if an LLC is to be taxed as a partnership for federal income tax purposes. For reasons which follow, this is not the case, although it may well have an impact on whether certain allocations of profits and losses for tax purposes will be respected by the IRS—for tax purposes only.

Capital accounting typically works as follows:

1. The company establishes for each member a “capital account,” which is a running balance of all capital contributions made by each member and all distributions made to the member;
2. The member’s initial capital account balance is the initial capital contributed to the company. For cash contributions, the value is obvious, but for property contributions, the members must agree on an appropriate “book value” that will be treated as the value of that contribution. This is entirely a matter of economic agreement between the members and should be addressed in the operating agreement.² The member’s capital account is *increased* each year by:
 - i. the amount of any additional cash contributed by the member to the company;
 - ii. the net agreed value (established by agreement among the members) for any non-cash property contributed to the company;
 - iii. any profits of the company allocated to that particular member (addressed below).

3. The member’s capital account is *decreased* each year by:

- i. any cash distributed by the company to that member;
- ii. the net agreed value (established by agreement among of the members) of any non-cash assets distributed to the member;
- iii. any losses of the company allocated to that particular member.

Capital accounting is only an accounting methodology. It does *not* mandate any particular economic treatment among the members/partners corresponding to the accounting results.

However, if this accounting method is to be meaningful, the member’s capital accounts become highly relevant in tracking their long-term economic relationship, particularly on the occurrence of key events in the entity’s life. For purposes of economic matters, these include rights to distributions, allocations of profits and losses, and, particularly, how money is distributed when the company is liquidated. Capital accounting language therefore can typically be found running through the entirety of the operating agreement when discussing these important events.

Capital Accounting in Operating Agreements: The Tax Background, How We Got Here, and the Typical Three-Prong Tax Provisions Found in Operating Agreements

As noted above, capital accounting is *not* mandatory for LLCs to be taxed as partnerships for federal income tax purposes. However, it *is* typically adopted for this purpose. Why?

Much of the original impetus for widespread adoption of the LLC format arose from a desire to have a business entity that could be treated as a partnership for federal income tax purposes, while enjoying corporate-like limited liability.³

Since partnership taxation was the reason for forming such entities in the first place, operating agreement forms, understandably, imported from the world of limited partnership agreements standard language designed to comply with IRS “safe harbors” for respecting the parties’ agreed allocation of profits and losses under the partnership taxation sections of the Internal Revenue Code. Under IRS regulations for partnership taxa-

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tion under IRC 704, which continue in effect until this day, members' allocations of profit and losses are respected if they have "substantial economic effect." The safe harbor provided that "economic effect" was present where the partnership agreement (or operating agreement) provides that, throughout the life of the entity :

1. capital accounts are maintained for each member, generally in keeping with the capital accounting method outlined above (as extensively detailed in the Treasury Regulations);
2. on liquidation of the entity, liquidation proceeds are distributed to the members only in accordance with positive capital account balances;
3. if a partner has a deficit balance in his or her capital account following the liquidation of the partner's interest in the partnership, that partner is obligated to restore the amount of such deficit balance to the partnership by the end of the taxable year ("Negative Capital Account Restoration").

See Treas Reg 1.704-1(b).

Note that there are two "events" that the regulations mandate as the operative event for making sure that capital accounting has meaning: (1) the liquidation of the entity, and (2) the liquidation of a particular member's interest in the entity. In the first instance, only members having positive capital account balances receive distributions, and in the second any partner having a deficit must restore it, whether on liquidation of the entity as a whole or only of that partner's interest.

Qualified Income Offsets and Limited Liability Companies

For limited liability companies (and for limited partnerships), Negative Capital Account Restoration presented a major problem: members expected to enjoy limited liability, and yet the safe harbor, if mandated, would create a potentially unlimited obligation to contribute capital to the company just to meet the economic effect test, primarily so that loss allocations would be respected. For LLCs, the member's intentions were that *no* member ever had to restore a negative capital account (unlike a limited partnership where the general partner would have such a responsibility under limited partnership laws).

In response to this dilemma, the IRS regulations provided an alternative to Negative Capital Account Restoration in the form of

the so-called "alternative economic effect test." Under this test, capital accounting was likewise required, as was liquidation in accordance with positive capital account balances. However, the operating agreement could substitute a so-called qualified income offset provision for Negative Capital Account Restoration. A qualified income offset provision mandates that partners who unexpectedly receive an adjustment, allocation, or distribution that brings their capital account balance negative will be allocated all income and gain in an amount sufficient to eliminate the deficit balance as quickly as possible.

Under the regulations, only allocations of losses that do *not* drive a partner into a negative capital account situation are protected.⁴ Thus, if the alternative economic effect test is adopted in such a way that the company's loss allocations will always be respected, losses will be allocated only among members having positive capital accounts until all positive capital accounts have been reduced to zero, after which a different treatment follows.

Non-Recourse Deductions and Minimum Gain Chargebacks

What would happen in the special case of a limited liability company where *all* members have zero capital accounts and then a loss occurs? How was that loss to be allocated? Such a condition could *only* occur where the entity had liabilities that exceeded the tax basis of its assets. Since no member was responsible to repay those liabilities because of the protection of limited liability, a loss deduction would have no economic effect under the traditional safe harbor or under the alternate economic effect test. Since all capital accounts would be reduced to zero (under my hypothetical), the second safe harbor has been complied with but does not resolve the issue.

So, the IRS regulations permitted the adoption of yet a second variation to cover "non-recourse" deduction, which is the inclusion of language in the operating agreement called a "minimum gain chargeback" provision. The effect of a minimum gain chargeback provision is really to mandate that if a non-recourse deduction is allocated to a particular member, positive income will later be allocated to that member if, when, and to the extent that the member's "share" of minimum gain is later reduced (which can occur, for example, when the non-recourse debt giv-

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ing rise to that deduction is paid down or the “underwater” property is sold for an amount sufficient to pay off the debt). Although these provisions are hyper-technical and will not be analyzed here, suffice it to say that such language is typical in operating agreement forms designed to produce tax “comfort” as far as deductions are concerned.

To summarize, because of these historical developments, it is typical to find in operating agreements provisions with these characteristics:

1. mandatory use of capital accounting;
2. agreeing on a percentage or other method of allocating profits and losses;
3. allocating losses only to members having positive capital account balances;
4. modifying the “normal” allocation of profits and losses (for tax and capital accounting purposes) by including a qualified income offset provision;
5. modifying the “normal” allocation of profits and losses pertaining to non-recourse deductions (for tax and capital accounting provisions) by including a minimum gain chargeback provision; and
6. providing for liquidation in accordance with positive capital account balances but no negative Capital Account Restoration is required.

For purposes of the rest of this article, I’ll call this the “Typical Language.”

An Illustration: Who Gets What on a Reversal of Fortune?

We come now to the central point of this article—taken as a whole, these provisions, even though developed as a tax compliance technique, mandate specific economic results among the members that may or may not be in keeping with their understanding.

Let’s take a simple example. Let’s assume that we have new clients, Jennifer and Brad, who want to form a new limited liability company to take advantage of their celebrity status and start a movie studio, perhaps to obtain the still-new Michigan Film Credit. They agree that Jennifer, who has most of the money, is going to contribute \$1,000,000 to the LLC to build the studio and produce movies. Brad will contribute no money, but will operate the studio and “make rain.” In their initial interview, they say simply that they want a “50-50 deal” and leave it to you to craft the deal.

What could be simpler—or, as with all things in the movie business, is it? Jennifer contributes the \$1,000,000, Brad runs it, and all goes well until their ugly celebrity break-up. They sell the movie studio for \$400,000, a loss of \$600,000 ignoring other factors, and it now comes time to distribute proceeds. Who gets the money?

Option 1 – The 50-50 “deal”

Brad and Jennifer came in asking for simply a “50-50 deal,” so, at least without more, the proceeds are distributed as follows:

Brad gets \$200,000 (1/2 of the proceeds), a gain of \$200,000.

Jennifer gets \$200,000 (1/2 of the proceeds) for an \$800,000 loss.

Option 2 – The Typical Language

If the operating agreement contains the Typical Language, the result differs vastly. The Typical Language mandates:

1. When Jennifer contributes the \$1,000,000, she receives a \$1,000,000 capital account. Brad has an opening capital account balance of *zero*.
2. When the movie studio is sold for \$400,000, there is a net \$600,000 loss. Although they would otherwise share profits and losses on a 50-50 basis, the presence of a restriction on allocating losses to members in such a way as to drive their capital negative means that *none* of that loss is allocated to Brad, who began with a zero capital account. So, all \$600,000 of the loss is allocated for book and tax purposes to Jennifer. Following that allocation, Jennifer has a \$400,000 capital account, Brad has zero.
3. After sale of the studio, the LLC is liquidated in accordance with positive capital accounts. Result?

Brad gets *zero*.

Jennifer gets \$400,000 (for a \$600,000 loss).

How About the Upside?

What if we change the facts so that the studio is sold not for \$400,000, but for \$3,000,000? What result then?

Option 1 Again, the Pure 50-50 Deal

Jennifer \$1,500,000 (a \$500,000 gain)

Brad \$1,500,000 (a \$1,500,000 gain)

Option 2 – Typical Language

1. Again, when Jennifer contributes the \$1,000,000, she receives a \$1,000,000 capital account. Brad has an opening capital account balance of *zero*.
2. When the movie studio is sold for \$3,000,000, there is a net \$2,000,000 gain. That gain, per the parties' agreement, is allocated 50-50. Since there is no loss allocation that would implicate the qualified income offset or minimum gain chargeback, it is allocated \$1,000,000 to Brad and \$1,000,000 to Jennifer. Capital accounts after this allocation are then:

Jennifer	\$2,000,000
Brad	\$1,000,000
3. The LLC is liquidated in accordance with positive capital accounts, so Jennifer gets \$2,000,000, and Brad gets \$1,000,000.

Interpreting the Results

A case can be made that, under either circumstance, Option 1 *or* Option 2 are economically "fair" and could be agreed on by reasonable minds who thought about it carefully. In the Reversal of Fortune scenario, under Option 1, from Brad's point of view, he ends up receiving "compensation" for his participation in the enterprise in the amount of \$200,000, and since he was 50-50, he also experienced a \$300,000 loss from his expectation to receive the full benefit of a \$500,000 contribution made by Jennifer. On the other hand, under Option 1, Jennifer bears the full economic weight of an \$800,000 cash loss (\$200,000 of which ends up in Brad's pocket). Option 2, on the hand, protects Jennifer's investment primarily, and Brad receives nothing.

In the upside scenario, since there is more money floating around, Option 1 produces a result that gives both parties 50 percent of the proceeds without going Jennifer's ox. Still, although they are sharing proceeds 50-50, they are not sharing *gain* 50-50. On a net end result basis, the *gain* is allocated \$1,500,000 to Brad and \$500,000 to Jennifer.

The problem of course is that Brad and Jennifer may never have thought about the specifics of result they wanted if their venture resulted in a loss, and they experienced a nasty celebrity breakup, or what they really meant by 50-50. In hindsight, it is possible that they meant simply that whatever happened on liquidation, those proceeds would be divided 50-50, regardless of the fact that Jennifer contributed all of the funds (an Option 1

approach). Or, perhaps if asked the question about this reversal of fortunes, they would have dictated that Jennifer would be paid back all of the proceeds until she received \$1 million, after which proceeds would be distributed 50-50. Or if asked the question in the context of an upside, perhaps they would have meant that it was the gain that was to be shared 50-50, not the proceeds.

Which result should obtain—Option 1 or Option 2? The illustration simply shows that even in the most rudimentary of LLC formation scenarios (like this one), we as practitioners have to ask the members what result they intend. There simply is no substitute for inquiry and discussion. Even though the technical language used to provide a tax safe harbor is hyper-technical, it simply cannot be treated as boilerplate legalese, because it *does*, and is intended to have, economic impact. This is why the IRS developed the approach in the first place. The point here is that the Typical Language mandates the Option 2 result, under which Jennifer loses, and Brad's possible expectations may be frustrated.

The Right Questions to Ask?

As the Brad and Jennifer example illustrates, uncritical use of capital accounting will mandate a particular accounting result, in this case the result of Option 2 on liquidation of the LLC, a result that may or may not be in keeping with the members intentions. The best way that I have found to avoid unintended results here is to tease out this economic issue by asking clients a series of questions designed to test their intentions under (at least) the two fact patterns illustrated above. Let me offer the following (suggested) script as a possibility:

"Jennifer and Brad, you've indicated that you want a "50-50 deal. But this means different things to different people. Let me ask you three questions to narrow down what *you* mean."

Question 1: Jennifer, let's say you contribute \$1 million to the LLC. Six months later the LLC proves unsuccessful. You and Brad want to give it up. You find a buyer who is willing to give back some but not all of your money, and offers \$500,000 to buy you both out. Who do you intend should receive the \$500,000? Should it be divided 50-50 between you, or does it all go to Jennifer?

Question 2: Let's say Jennifer contributes \$1 million to the LLC. Two years later, the LLC proves very successful. You decide

to sell it. A buyer offers you \$3 million, which you decide to take. Who gets the \$3 million? Does it get divided 50-50, or does the first million go to repay Jennifer and the balance get split 50-50?

Question 3: Let's say Jennifer contributes \$1 million. The day afterward, Brad dies. Jennifer decides to liquidate the company. Who gets the \$1 million? Does it all go back to Jennifer, or is it split 50-50 with Brad's estate?

Obviously, these questions are designed to test whether they want an Option 1 or Option 2 result. If they want an Option 2 result, then it is safe to mandate capital accounting, and you can use the Typical Language without remorse and without any special accounting adjustments in its implementation.

Question 3, in fact, serves an additional purpose to which I find that most clients give short shrift: Brad's part of the "deal" was to operate the studio, but his death leaves this impossible. Since Brad can't render these services, Jennifer isn't getting the value for which she bargained in reaching a 50-50 deal. If services are to be part of the economic arrangement, then capital accounting and a mandated Option 2 result simply do not account for this economic reality, and modifications must be made. In addition, it allows a discussion with Brad to the effect that if capital accounting is used and Brad receives credit for a capital accounting for services to be rendered, it is likely that Brad will recognize taxable income under IRC 83 the minute that his capital account is established and credited with half of the opening contribution.

But what if the answers direct you to an Option 1 result? Knowing what you now know about capital accounting and tax safe harbors, can you still use the Typical Language and achieve the safe harbor, but end up with an Option 1 outcome?

Having Our Cake and Eating it Too

The answer is *yes*. Recall that capital accounting is a *financial* accounting method, rather than principally a tax accounting method. With the tax safe harbor in mind, it is understandable that practitioners will prefer using the Typical Language rather than accomplishing the same tax protection by a hand-crafted means.

The way to achieve this result is to use the Typical Language for capital accounting, *but* to have the parties agree on a so-called "book up" for financial accounting purposes.

A book up gives Brad "credit" within the operating agreement for his contribution of an "asset" — goodwill — with a value of \$1 million. While the good will may be illusory, it results in recording an additional \$1 million asset and a corresponding credit of \$1 million to Brad's book capital account. Then, you can feel confident that if you include language that liquidation will be made to members having positive (book) capital accounts, it will result in a distribution of 50 percent to Brad and 50 percent to Jennifer, whether it is a loss or a gain.

This is deceptively simple, as it comes with some tax complexities. Since Brad has contributed an asset with zero tax basis (goodwill) but a credit of \$1 million on his book capital account, the rules of IRC 704(c) would mandate that *tax* (not book) income be allocated among Brad and Jennifer in such a way as to reduce that book-tax difference as rapidly as possible. The regulations specify various permissible methods for doing so. The 704(c) regulations are well beyond the scope of this article, but I raise the point to explain why practitioners must be intentional in their use of this accounting technique as well.

Still, these tax issues aside, the book up does achieve the result of being able to use capital accounting and therefore complies with the tax safe harbor under IRC 704(b), permitting a true 50-50 deal in the Option 1 sense.

Conclusion

My principle exhortation to my fellow attorneys who are forming LLCs as business entities is simply to be intentional and critical when adopting the Typical Language into their standard operating agreements. Capital accounting, without adjustment, mandates specific economic results among the members — results that will have an impact in making distributions, allocating profits and losses, and particularly in allocating distribution proceeds when the LLC is liquidated. When the clients' intentions are discovered using a series of questions like the kind outlined above (and there are many other good ones that other practitioners are using as well), you can determine whether (a) you want to use capital accounting since the parties intend the result that it dictates, (b) you want to use capital accounting but need a "book up" or other modification in order for the economic results to be correct, or (c) you

want to avoid using capital accounting at all and are comfortable with an entity approach to equity accounting, in which case you will simply have to test on a yearly basis whether the parties' allocations of profits and losses for tax purposes will be respected.



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NOTES

1. Capital accounting does not address *non*-equity transactions between members and the company, such as, for example, member loans. In fact, use of member debt in this way is a typical means used to avoid the effect of normal capital accounting rules, although it does present its own tax complexities.
2. Although the tax basis of the property contributed may well have an impact on the allocations of deductions among the members for tax purposes, that difference has no impact on the financial accounting for the item contributed.
3. The ancestors of limited liability company operating agreements were developed at a time before the IRS check-the-box regulations permitted election of any other treatment, so the main tax issue was whether the operating agreement, on its face, complied with IRS regulations differentiating for tax purposes between partnerships, on the one hand, and associations taxed as corporations under IRC 7701, on the other. While the check-the-box regulations have done away with the need for drafting with this issue in mind, legacy operating agreements sometimes continue to have language directed toward it.
4. Treas Reg 1.704-1(d).