Capital Shifts and Ownership Changes

L. Andrew Immerman
Alston & Bird LLP
Atlanta, Georgia
andy.immerman@alston.com

The *Lehman* Case

- Authority on partnership capital shifts is sparse, and most of the little authority that exists deals with service-related shifts.
- The seminal case on partnership capital shifts is *Lehman v. Commissioner*, 19 T.C. 659 (1953).
  - In *Lehman*, each partner contributed $10,000 to the capital of a limited partnership.
  - Under the partnership agreement once the amount that the other partners earned or received exceeded a $50,000 hurdle, each of the petitioners (husband and wife) ***became entitled to $5,000 in credits on the books of the partnership, with a like amount deducted from the capital contributions of the other partners.***
  - The husband was the sole general partner and ran the business; the wife held only a limited partner interest and there is no indication in the court's opinion that she provided services.
  - The credits were actually made on the partnership's books in the year following the year in which the petitioners became entitled to the credits.
- The court held that the petitioners were required to include $10,000 in income.
- Moreover, they were required to report the amount in the year they became entitled to the credit, even though the partnership books did not reflect the credit until the following year.

The *Lehman* Case

- The $10,000 capital shift in *Lehman* arguably was made entirely in consideration of the husband's performance of services.
  - However, the court saw no need to determine the reason for the capital shift except to point out that the shift concededly was not a gift from the other partners.
  - *Lehman* does not distinguish capital shifts that take place as compensation for services from other capital shifts; the court did not consider it "crucial whether the transfer to petitioners' capital accounts was in fact 'compensation' for [petitioner husband's] services.
  - According to the court: "Surely the increase resulted in a gain or profit to [the Lehmans]."
- The court considered the situation:
  - "no different in its tax consequences than if the partners had paid over to petitioners the $10,000 under an arrangement whereby petitioners agreed to use that sum to increase their investment in the partnership with a corresponding reduction in the capital shares of the other partners."

The *Lehman* Case

- The court does not say whether the investor partners were entitled to a deduction with respect to the capital shifted to the Lehmans.
  - If the capital shift was compensatory, the investors very likely would have been entitled to a deduction.
- Nor does the court say whether the investor partners had to recognize any taxable income.
  - Could it be argued that the investor partners in effect used appreciated property (the partnership interest) to pay an obligation (the amount owed to the Lehmans)?
  - There is not much authority but many advisors would take the position that the investor partners do not recognize gain.

Other Cases

- Later cases test for the existence of a capital shift by asking what the results would be on a hypothetical liquidation.
  - If the LLC were to sell all its assets at fair market value and distribute the proceeds to the members in liquidation, would any members receive the capital of other members?
- For example, *Mark IV Pictures, Inc. v. Commissioner*, 969 F.2d 669 (8th Cir. 1992), *aff'g* 60 T.C.M. (CCH) 1171 (1990), states that:
  - "[t]o determine whether an interest is a capital one, we examine the effects of a hypothetical liquidation occurring immediately after the partners received their interests which, in this case, was the date the partnerships were formed" (citing a leading treatise).
- This test was recently applied in *Crescent Holdings, LLC v. Commissioner*, 141 T.C. No. 15 (2013). *See also Hensel Phelps Construction Co. v. Commissioner*, 74 T.C. 939 (1980), *aff'd*, 703 F.2d 485 (10th Cir. 1983); *Johnston v. Commissioner*, 69 T.C.M. (CCH) 2283 (1995).
- All the cases cited here arose in connection with service-related shifts, but similar reasoning may apply to capital shifts of other kinds.

Treasury Regulations

- In addition to the judicial authorities, the Treasury Regulations under Section 721(a) of the Code offer limited guidance on the tax consequences of a capital shift.
- Section 721, where it applies, prevents both the contributing partner and the partnership from recognizing gain.
- However, Treas. Reg. Section 1.721-1(b)(1) contrasts the normal situation -- in which a partner is entitled to be repaid its contributions and Section 721 provides for nonrecognition -- with the less common situation in which a partner gives up, in favor of another partner, some or all of its right to repayment of its capital contribution:

  > "To the extent that any of the partners gives up any part of his right to be repaid his contributions (as distinguished from a share in partnership profits) in favor of another partner as compensation for services (or in satisfaction of an obligation), section 721 does not apply."

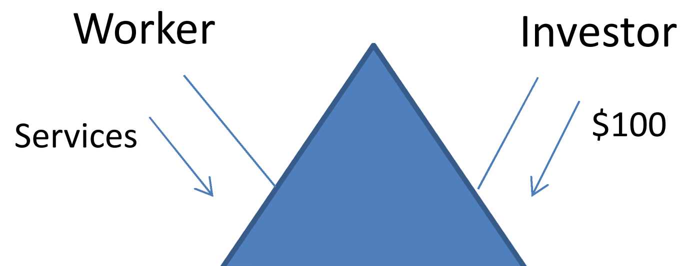
- Under *Lehman* and the other cases, when -- or even whether -- the capital shift is actually reflected on the books of the partnership should make no difference to the tax consequences.

Capital Shift as "Guaranteed Payment"

- Treas. Reg. Section 1.721-1(b)(2) analyzes a compensatory capital shift as a "guaranteed payment for services" within the meaning of Code Section 707(c).
  - A guaranteed payment generally includes any payment to a partner for services or the use of capital, but only "to the extent determined without regard to the income of the partnership."
- A guaranteed payment need not be "guaranteed" in any commonly understood sense of the word; it is simply a payment that is determined without regard to the partnership's income.
  - Payments to a partner not acting in its capacity as a partner, however, are subject to the slightly different rules of Code Section 707(a), and are not classified as guaranteed payments.
- A "guaranteed payment" as defined in Code Section 707(c) may be made either for services or for the use of capital.
  - Although authority is lacking, if a capital shift for services is a guaranteed payment, then by the same logic a capital shift for the use of capital may be a guaranteed payment as well.

Compensatory Capital Shift in New Partnership

- Worker and Investor form a partnership.
  - On day one Worker contributes services (but no cash or other property).
  - On day one Investor contributes $100.
  - The operating agreement says split all distributions 50/50.
- There is a capital shift of $50 from Investor to Worker.



On immediate liquidation:

-Worker gets $50

-Investor gets $50

- The capital shift probably occurs on day one (despite the absence of any imminent liquidation or other distribution).
- Consensus view is that the capital shift is current compensation income to Worker and a deductible compensation expense to Investor.
  - But don't assume the amounts of the income and expense are necessarily $50.

The "Profits Interest" Alternative

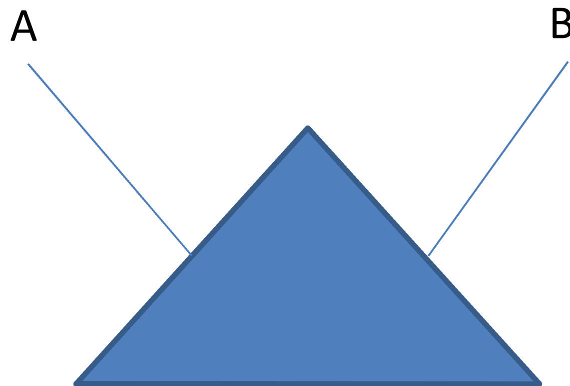
- The compensatory capital shift in examples like this is typically avoided by structuring Worker's interest as a "profits interest."
- Rev Proc 93-27, 1993-2 CB 343, defines two types of partnership interests, as determined at the time of issuance:
  - Capital Interest: partnership interest that would entitle the holder to a share of liquidation proceeds if partnership assets were sold at FMV.
  - Profits Interest: partnership interest that is not a capital interest; generally entitles holder only to a share of post-issuance partnership income and gain.

Structuring a Profits Interest

- If Worker has a profits interest, he would receive nothing if the partnership immediately liquidated.
  - However, he could receive a share of future profits, including appreciation in value.
  - His share of future profits could be higher than 50% if the parties agree. For example, he could be entitled to all of the first $100 of appreciation to bring him up to where he might have been if he had contributed $100 in the first place.
- The 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.
  - The interest is not disposed of within two years.
  - The interest is not a limited partnership interest in a publicly traded partnership.
- Parties that are accustomed to businesses organized as corporations, and who have not worked extensively with LLCs and partnerships, are very likely to enter into transactions that inadvertently cause a taxable capital shift to service providers.
  - The problem of inadvertent capital shifts to service providers is remarkably widespread.

Compensatory Capital Shift in Existing Partnership

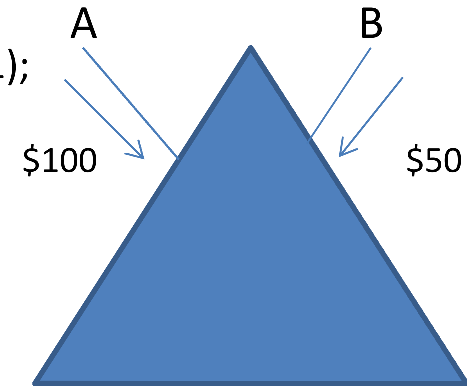
- Another typical example: LLC with A and B as members wants to give C, an employee, an interest in the LLC.
  - Suppose A and B formed LLC on 1/1/14 by contributing $10 each.
  - On 1/1/15, LLC is worth $150 (i.e., if the assets of the LLC were sold at fair market value and the proceeds distributed, the members would receive $150)
  - A and B they want to bring in C, a service provider, and give him a "1/3 interest."



- If C gets a straight "1/3rd interest," there is a capital shift from A and B to C; C presumably has taxable income.
- However, C's interest might instead be tax-free is structured as a profits interest. If so:
  - A and B would get ***all $150 on an immediate liquidation*** but C could participate in future profits (including future appreciation in value).
  - C should not participate in ***any*** of the $150 built-in value on an immediate liquidation, even though A and B only contributed $10 each.

Preferred Return Without Capital Shift

A & B form an LLC. A puts in $100, and B puts in $50.
Distribution "waterfall":
(i) First, to A until A gets a cumulative 20% annual return ($10 for year 1);
(ii) Then to return A's capital contributions;
(iii) Then to return B's capital contribution; and
(iv) Thereafter, equally to A and B.



However, liquidating distributions are in accordance with capital accounts.

The LLC earns just $7 for year 1, all of its allocated to A:

	A	B	Total
Beginning Capital Account	$100	$50	$150
Allocation of income	$7	$0	$7
Ending Capital Account	**$107**	**$50**	**$157**

Because liquidating distributions are in accordance with capital accounts, there is no capital shift, but A would not get its full 20% preference if the LLC liquidated at the end of year 1

Preferred Return With Capital Shift

On the other hand, if all distributions – ***including liquidating distributions*** -- are in accordance with the same "waterfall," there would be a capital shift.

Step 1: Starting capital account balances: A=$100 and B = $50

Step 2: Distributions on hypothetical liquidation:

	A	B	Total
Preferred Return	$10	-	$10
Return of A's Capital	$100	-	$100
Residual Returns B's Capital		$47	$47
Total to be Distributed	**$110**	**$47**	**$147**

So, on liquidation, $3 of B's $50 of capital is shifted to A.

- Must A report a taxable capital shift in year one (even if A does not actually receive any distribution)? Can A argue it has made a "bargain purchase" and has realized no gain?
- The capital shift arose because the LLC income was insufficient to satisfy A's preferred return and instead some of B's capital had to be shifted to A.

Was the Capital Shift Intended?

- It used to be most common for LLC agreements to allocate profits and losses in accordance with "layers," and to liquidate in accordance with capital accounts.
- Nowadays it is probably more usual for LLCs to liquidate in accordance with a specified waterfall, and allocate profits and losses in such as way as to cause capital accounts to hit the "targeted" waterfall, without allowing capital accounts to control liquidating distributions.
- In most instances the distributions made under the two different drafting approaches will be identical.
- In general, targeted allocations best ensure that distributions will be made as intended, even if targeted allocations leave more room for doubt as to the validity of the allocations.
  - ***However, keep in mind the possibility that distributions in accordance with a waterfall may create a capital shift, and consider whether such a capital shift is intended.***
  - Is it possible that the parties intended that A's preference be paid only out of earnings, and did not realize that the targeted approach could be inconsistent with that intent?

Forfeiture As Penalty for Failing to Honor a Capital Call

- Assume A has a $1,000 capital account.
  - The members of LLC have agreed that there will be mandatory capital calls.
  - Upon its failure to meet the capital call, a member forfeit all of his capital.
- On failing to meet a capital call, A forfeits its $1,000 capital account in favor of the members that do honor the capital call.
- Upon the forfeiture, $1,000 of capital has shifted from A to the other members.

Income to the Remaining Partners?

Some alternative theories:

- Most likely: Current taxable income to the remaining partners in the amount of the capital that has shifted from the defaulting partners to them.
- Reasonably likely: Current taxable income to the remaining partners equal to the fair market value of the forfeited interest of the defaulting partners, which may differ from the capital being shifted (for example, because of minority discounts or marketability discounts).
- Unlikely: No current taxable income, but with special allocations (i.e., partnership allocates items of gross loss or deduction to the defaulting partners and/or items of gross income or gain to the remaining partners until the capital accounts have caught up with the hypothetical liquidating distributions).
- Very aggressive: No current taxable income, and no special allocations. Remaining partners presumably recognize gain on disposing of their interests (or receiving distributions in excess of basis).