

Key Tax Provisions in LLC Operating Agreements: Interpreting Special Allocation, Safe Harbor, DRO, QIO Clauses

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December 14, 2021

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Understanding Boilerplate Language in Partnership Agreements

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1. OVERVIEW

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Overview

- *Special Allocations
- *Will IRS Accept Allocations
- *Safe Harbor Agreements
- *Basic Safe Harbor Agreement
- *Alternative Safe Harbor Agreement
- *Economic Equivalence Test
- *Additional Provisions

Overview

Challenging Terms

“Book” – Can be used to mean the “books and records of the company” no matter what method is used to calculate capital accounts

“Book” – Can be used under Section 704(b) “book” capital accounts. The “book” doesn’t mean “books and records”. It is a term of art that equates to using FMV at the time of contribution, as opposed to using the member’s original cost at the time of contribution. To confuse matters further, Section 704(b) is part of the “tax code”. It is a tax concept, even though it uses the term “book”. Additionally, there is another tax concept called “tax capital”. Tax Capital uses the members original cost at the time of contribution.

Remember, when we use the term “basis” we are traditionally referring to a member’s share of liabilities PLUS that member’s share of the capital account (or equity). When we use the term “capital account” we are referring to a member’s equity, which doesn’t include liabilities.

Special Allocations

Special Allocations

- S Corporations do not allow for special allocations of items of income, expense, gain, or loss to shareholders
- All items must be allocated per share per day
- Partnerships can specially allocate all items listed above

S Corporations

S Corporations must allocate all items of income, expense, gain, loss, distributions per share per day.

- Example – Marcia, Jan and Cindy own Brady Bunch Lunches, Inc. (“Brady”) is an S Corporation. Brady has gross income of \$1,200 and expenses of \$300. Marcia, Jan and Cindy must each be allocated \$400 of gross income (33.3%) and \$100 of expenses (33.3%). Marcia, Jan and Cindy will report \$300 of taxable income on their individual tax return.
- If the S Corp specially allocated the \$1,200 of gross income in the following manner – Marcia - \$600; Jan \$300 and Cindy \$300, Brady could lose its status as an S Corp.

Partnerships

Partnerships can specially allocate items of income, expense, gain, loss, and distributions under certain circumstances.

- Example – Arya, Sansa, Tyrion and Cersei each own 25% of Valerian Steel LLC (“Steel”). Steel is a limited liability company (“LLC”). Steel has gross income of \$1,200 and depreciation deductions \$400. Arya, Sansa, Tyrion and Cersei will be allocated \$300 ($\$25\% \times \$1,200$) of gross income. They do not have to each be allocated \$100 ($25\% \times \400) of depreciation deductions. Tyrion can be allocated \$200 (50% of \$400). The remaining \$200 of depreciation expense can be allocated to Arya, Sansa and Cersei pro-rata.
- Steel can “specially allocate” items to its members if certain requirements are met.

Sample LLC Agreement

Squarepants and Starfish, LLC

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2. SUBSTANTIAL ECONOMIC EFFECT

Substantial Economic Effect

The Internal Revenue Service will accept special allocations to members if those allocations have Substantial Economic Effect (“SEE”). SEE is 2 separate tests. The first test is the Economic Effect Test (“EE”). The second test is the Substantial Test.

Substantial Economic Effect

What does EE mean?

EE means that a taxpayer who receives a tax benefit must also receive an economic burden.

Alternatively, a taxpayer who receives a tax burden must also receive an economic benefit.

S means that the allocations can not be transitory or shifting. Discuss examples.

Substantial Economic Effect

Penny, Sheldon and Leonard own a hair salon. It's an LLC called Bigger Bangs, LLC ("Bangs").

Bangs has \$300 in depreciation deductions. Bangs wants to allocate \$200 in depreciation deductions to Penny, while the remaining \$100 in depreciation deductions will then be allocated pro-rata to Sheldon and Leonard.

This is a special allocation of depreciation expense to Penny and will be respected by the IRS if it has SEE. **Let's assume the allocation is substantial.**

Substantial Economic Effect

For special allocations to have EE (let's assume its substantial), then the following would have to occur:

Penny suffers a tax benefit by being able to deduct the \$200 of specially allocated depreciation expense in order to reduce her taxable income from Bangs.

Penny must suffer an economic burden because her capital account will be decreased by \$200 which means she will receive less money when Bangs liquidates.

3. SAFE HARBOR AGREEMENTS

Safe Harbor Agreements

Will IRS Accept Special Allocations?

- The IRS will respect special allocations to members automatically if the entity's agreement contains special boilerplate language
- Without this special boilerplate language, the IRS may challenge an LLC's special allocations and re-allocate certain items
- These agreements are called "Safe Harbor Agreements"

Safe Harbor Agreements

- 3 Types of Safe Harbor Agreements
 - Basic
 - Alternative
 - Economic Equivalence

3. SAFE HARBOR AGREEMENTS

Basic or Primary Safe Harbor Agreement

Basic Safe Harbor Test

Basic Safe Harbor Agreement Requirements

- Maintain Section 704(b) capital accounts
- Liquidate according to positive capital accounts
- Deficit Restoration Obligation (“DRO”)

Basic Safe Harbor Test

- Requirement #1 - Maintain Section 704(b) capital accounts
 - Capital Accounts are increased by cash contributions; FMV of property contributions (net of liabilities); current year Section 704(b) income including tax exempt income; positive Section 734(b) revaluations
 - Capital Accounts are decreased by cash distributions, FMV of property distributions (net of liabilities); current year Section 704(b) loss including nondeductible expenses; negative Section 734(b) revaluations

FINDING BOILERPLATE LANGUAGE

Safe Harbor Agreement – Requirement #1

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#1 - Maintain Section 704(b) Capital Accounts

Maintenance of Capital Accounts

"Capital Account" means, with respect to any Member, the Capital Account maintained for such Member in accordance with the following provisions:

#1 - Maintain Section 704(b) Capital Accounts

To each Member's Capital Account, there shall be debited: (A) the amount of money and the Gross Asset Value of any Property distributed to such Member pursuant to any provision of this Agreement, (B) such Member's distributive share of Losses and any items in the nature of expenses or losses (including non-deductible expenses) which are specially allocated, and (C) the amount of any liabilities of such Member assumed by the Company or which are secured by any Property contributed by such Member to the Company; In the event an Interest is Transferred in accordance with the terms of this Agreement, the transferee shall succeed to the Capital Account of the transferor to the extent it relates to the Transferred Interest.

#1 - Maintain Section 704(b) Capital Accounts

"The foregoing provisions and the other provisions of this Agreement relating to the maintenance of Capital Accounts are intended to comply with Regulations Section 1.704-1(b) and shall be interpreted and applied in a manner consistent therewith. In the event the Manager shall determine that it is prudent to modify the manner in which the Capital Accounts, or any debits or credits thereto (including, without limitation, debits or credits relating to liabilities which are secured by contributed or distributed property or which are assumed by the Company

#1 - Maintain Section 704(b) Capital Accounts

When reviewing an operating agreement, the following sections should be reviewed in order to locate the proper boilerplate language to maintain Section 704(b) capital accounts:

- 1) Definitions
- 2) Profit and Loss
- 3) Capital Accounts

#2 – Liquidate with Positive Capital Accounts

The first requirement under the Basic Safe Harbor Test is to maintain Section 704(b) capitals accounts. The second requirement is to liquidate according to those capital accounts.

FINDING BOILERPLATE LANGUAGE

Basic Safe Harbor Agreement Requirement #2

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#2 - Dissolution and Winding Up Section

“The Liquidator shall cause the proceeds from the liquidation to be applied, to the maximum extent permitted by law, in the following manner:

First, to creditors in satisfaction of all Company’s Debts and other liabilities;

Second, to Members and former members of the Company in satisfaction of liabilities for loans made to the Company not in the member’s capacity as a member

#2 -Dissolution and Winding Up Section

“the balance, if any, to the Members in accordance with the positive balance in their Section 704(b) Capital Accounts”

EXERCISE

Sufficient Language For Safe Harbor?

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#2 - Liquidating According to positive balance in their Section 704(b) Capital Accounts

What about these alternatives? What words would make each provision technically correct?

- 1) Liquidating according to the balance in their Section 704(b) capital accounts?
- 2) Liquidating according to the balance in their positive capital accounts?
- 3) Liquidating according to their capital accounts?
- 4) Liquidating according to the balance in their Section 704(b) positive capital accounts but if a balance remains, then based on profit percentages?

#3- Deficit Restoration Obligation

For special allocations to fall under the Basic Safe Harbor Test, the operating agreement must contain a **Deficit Restoration Obligation** (DRO).

A DRO is an unconditional and unlimited obligation to restore a member's capital account should it fall below zero.

Most members will not sign an operating agreement with a DRO as it is an unconditional unlimited obligation to contribute cash into the entity after its liquidated (or 90 days later).

FINDING BOILERPLATE LANGUAGE

DRO – Requirement #3

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#3 - Deficit Restoration Obligation

“Except as otherwise provided, if any Member has a deficit balance in this or her Capital Account (after giving effect to all contributions, distributions and allocations for all Allocation years, including the Allocation Year during which such liquidation occurs), such Member shall have an obligation to make any contribution to the capital of the Company with respect to such deficit, and such deficit shall not be considered a Debt owed to the Company or to any other Person for any purpose whatsoever”.

#3 -Deficit Restoration Obligation

Note – Some operating agreements contain a **limited DRO** which is an obligation to contribute cash to the entity for a deficit capital account up to a specified amount (not unlimited) but still an unconditional obligation.

When analyzing an operating agreement for the inclusion of a DRO, please search the following sections:

- 1) Definitions
- 2) Member's Liability
- 3) Winding Up

3. SAFE HARBOR AGREEMENTS

Alternative Safe Harbor Agreement

Alternative Safe Harbor Agreement

Alternative Safe Harbor Agreement

- Maintain Section 704(b) capital accounts – Basic Test
- Liquidate according to positive Section 704(b) capital accounts – Basic Test
- Qualified Income Offset
- Loss Limitation Provision
- Minimum Gain Chargeback

Alternative Safe Harbor Agreement

Qualified Income Offset (“QIO”)

Unlike the DRO, the QIO is not an unconditional, unlimited obligation to restore a member’s deficit capital account by contributing cash upon liquidation (or 90 days later).

Instead, the QIO is a special allocation of income to a member whose capital account is below zero. There is no need for a cash contribution.

FINDING BOILERPLATE LANGUAGE

DRO – Requirement #3

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#3 - Qualified Income Offset

“In the event a Member **unexpectedly** receives any adjustments, allocations or distributions described in Sections 1.704-1(b)(2)(ii)(d)(4), 1.704-1(b)(2)(ii)(d)(5) or 1.704-1(b)(2)(ii)(d)(6) of the Regulations, items of Company income and gain shall be specially allocated to such Member in an amount and manner sufficient to eliminate, to the extent required by the Regulations, the Adjusted Capital Account Deficit of the Member as quickly as possible, provided that an allocation pursuant to this Agreement shall be made only if and to the extent that the Member would have an Adjusted Capital Account Deficit after all other allocations provided for in this Agreement have been tentatively made”.

#4 -Qualified Income Offset

The QIO is only supposed to be used in “unexpected situations”.

The QIO generally only permits allocation of net taxable income.

When analyzing an operating agreement to search for a QIO (and the remaining provisions), please look at the following sections:

- 1) Definitions
- 2) Allocations
- 3) Winding Up

#3 - Qualified Income Offset

Remember our friend from the Basic Test (is this a sufficient QIO)?

“Except as otherwise provided, if any Member has a deficit balance in his or her Capital Account (after giving effect to all contributions, distributions and allocations for all Allocation years, including the Allocation Year during which such liquidation occurs), such Member shall have NO obligation to make any contribution to the capital of the Company with respect to such deficit, and such deficit shall not be considered a Debt owed to the Company or to any other Person for any purpose whatsoever”.

#3.1 - Gross Income Allocation

What if the allocation isn't unexpected? Does the below boilerplate language help?

“In the event a Member has a deficit Capital Account at the end of any Allocation Year which is in excess of the sum of : (i) the amount such Member is obligated to restore pursuant to the penultimate sentences of Regulations Sections 1.704-(2)(g)(1) and 1.704-2(i)(5), each such Member shall be specially allocated items of Company **gross** income and gain in the amount of such excess as quickly as possible...”

#3.2 - Curative Allocations

Can the below boilerplate language suffice if the operating agreement does not contain a QIO?

“The allocations set forth in this Agreement hereof are intended to comply with certain requirements of the Regulations under Section 704(b). It is the intent of the Members that, to the extent possible, all Regulatory Allocations shall be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this Agreement. Therefore, notwithstanding any other provision of.....”

#3.2 - Curative Allocations

this Agreement (other than the Regulatory Allocations) to the contrary, the Manager shall make such offsetting special allocations of Company income, gain, loss or deduction in whatever manner he determines appropriate so that, after such offsetting allocations are made, each Member's Capital Account balance is, to the extent possible, equal to the Capital Account balance such Member would have had if the Regulatory Allocations were not part of the Agreement.”

The Apple Problem

The “Apple” Problem:

Example #1: Jerry, Elaine and George are friends. There are 3 apples. Each person “deserves” 1 apple. Jerry gets his apple but can’t eat it because he had root canal surgery. Elaine eats half of her apple but is full and doesn’t eat anymore . George eats three quarters of his apple when he realizes it “disagrees” with his stomach.

Example #2 – Jerry, Elaine and George are friends. There are 3 apples. Jerry doesn’t deserve an apple. So, Elaine and George gets 1.5 apples each. Jerry doesn’t get an apple.

The Apple Problem

There is a difference between being “**properly**” **allocated** a tax loss and being **able to deduct** the entire loss on Form 1040. Members who receive a properly allocated loss jump through several hoops in order to recognize the loss on their Form 1040:

Section 704(d) - Does the taxpayer have sufficient outside basis to take the loss?

The Apple Problem

Section 465 – Even if the taxpayer has sufficient outside basis to take the loss, does the taxpayer have sufficient “at risk” basis?

Section 469 – Is the taxpayer a passive investor in the LLC? If so, the passive activity loss rules will not allow the member to deduct the loss on his Form 1040 despite having sufficient outside basis under Section 704(d) and Section 465.

The above assumes that the taxpayer “deserves” the loss to begin with. This is called “a properly allocable loss” and before the taxpayer gets a chance to try to deduct it, the loss must be properly allocable under Section 704(b).

FINDING BOILERPLATE LANGUAGE

Loss Allocation Provision – Requirement #5

#5 - Loss Limitation Allocation Provision

“Losses allocated pursuant to this Agreement hereof shall not exceed the maximum amount of Losses that can be allocated **without causing any Member to have an Adjusted Section 704(b) Capital Account Deficit** at the end of any Allocation Year. In the event some but not all of the Members would have Adjusted Capital Account Deficits as a consequence of an allocation of Losses pursuant to this Agreement hereof, the limitation set forth in this Agreement

#5 - Loss Allocation Provision

shall be applied on a Member by Member basis, and Losses not allocable to any Member as a result of such limitation shall be allocated to the other Members in accordance with the positive balances in such Member's Capital Accounts so as to allocate the maximum permissible Losses to each Member under Section 1.704-1(b)(2)(ii)(d) of the Regulations. hereof.”

Where to find the provision: Definitions; Allocations

What Does this Mean?

A member's "adjusted Section 704(b) capital account" is equal to his Section 704(b) capital account plus any **recourse debt** allocated to him, any **minimum gain** allocated to him, as well as any **limited DRO** signed by the member.

This amount, "adjusted Section 704(b) capital account" can not go below zero due to an allocation of loss. Instead, the other members will get his share of the "applicable loss".

#6 - Minimum Gain Chargeback

Example – Daryl and Negan contribute \$100 each. They borrow \$800 from the bank and use the \$1,000 to purchase a building called The Sanctuary. The building is depreciated using the S/L method over a 10 -year useful life period. Principal will not be paid back until the end of the 10 years:

Year 1 - \$1,000 - \$100 = \$900 NBV

Year 2 - \$900 - \$100 = \$800 NBV

#6 - Minimum Gain Chargeback

Year 3 - $\$800 - \$100 = \$700$ NBV

Year 4 - $\$700 - \$800 = \$600$ NBV

There is minimum gain starting in Year 3 of \$100. Minimum gain occurs when the net book value of the asset is below the loan amount of the debt. The debt remains every year at \$800. In year 3, the net book value of the asset is \$700. So, there is \$100 of minimum gain. In year 4, the net book value of the asset is \$600. So, there is \$200 of minimum gain.

#6 - Minimum Gain Chargeback

Why is minimum gain important? It is important as it increases a taxpayer's "adjusted Section 704(b) capital account" which is used to properly allocate losses to each member.

FINDING BOILERPLATE LANGUAGE

Minimum Gain – Requirement #6

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#6 - Minimum Gain Chargeback

“In the event that minimum gain is used to allocate otherwise applicable losses to a member, the Section 704 (b) rules of minimum gain chargeback should be applied to all future allocations of loss”.

#6 - Minimum Gain Chargeback

Minimum gain is a complex concept and will be explored in an upcoming webinar.

Where to find the provisions:

Definitions

Special Allocations

Minimum Gain

3. SAFE HARBOR AGREEMENTS

Economic Equivalence Safe Harbor Agreement

Economic Equivalence Test

Economic Equivalence Test

- Missing certain provisions of the Basic/Alternative Test
- Despite the missing language, the IRS will still respect the allocations
- “Dumb but lucky!”

Additional Boilerplate Language

Section 754 Elections: Section 743(b) adjustments

Example – Hogan, Flair, Austen and Johnson own 25% each of an entity called Wind and Water Energy, LLC (“WWE”).

McMahon, a third party, decides to purchase Hogan’s interest for \$5,000. The interest was worth \$3,000 to Hogan. So, Hogan sells McMahon his interest in WWE outside the LLC.

Because McMahon, who paid the FMV of \$5,000, must step into the shoes of Hogan’s inside basis, whose interest was worth \$3,000, WWE must record a “step up” in the amount of \$2,000.

FINDING BOILERPLATE LANGUAGE

Section 754 Elections

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Section 754 Elections: Section 743(b) adjustments

“To the extent an adjustment to the adjusted tax basis of any Company asset, pursuant to Code Section 734(b) or Code Section 743(b) is required, pursuant to Regulations Section 1.704-1(b)(2)(iv)(m)(2) or 1.704-1(b)(2)(iv)(m)(4), to be taken into account in determining Capital Accounts as the result of a distribution to a Member in complete liquidation of such Member's Interest,

Section 754 Elections: Section 743(b) adjustments

the amount of such adjustment to Capital Accounts shall be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases such basis), and such gain or loss shall be specially allocated to the Members in accordance with their Interests in the event Regulations Section 1.704-1(b)(2)(iv)(m)(2) applies, or to the Member to whom such distribution was made in the event Regulations Section 1.704-1(b)(2)(iv)(m)(4) applies.

Detailed examples of the above will be provided in an upcoming webinar.

Section 704(c) – Built in Gains

Example - John, Paul, George and Richard form an LLC called “The Oneders”. John, Paul and George each contribute cash in the amount of \$1,000. Richard contributes a building which cost him \$600 but is now worth \$1,000 at the time of contribution.

Richard has contributed a Section 704(c) built in gain asset. The built-in gain is calculated as \$400 (= \$1,000 - \$600). Because this asset already has a gain in the amount of \$400 which Richard has not paid taxes on, this Section 704(c) difference must be tracked by the LLC to ensure that the built-in gain is not shifted to the non-contributing members.

FINDING BOILERPLATE LANGUAGE

Section 704(c) Built in Gains

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Section 704(c) – Built in Gains

“In accordance with Code Section 704(c) and the 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 Members so as to take account of any variation between the adjusted basis of such Property to the Company for federal income tax purposes and its initial Gross Asset Value (computed in accordance with the definition of Gross Asset Value).

Section 704(c) – Built in Gains

“In the event the Gross Asset Value of any Company asset is adjusted pursuant to subparagraph (ii) of the definition of Gross Asset Value, subsequent allocations of income, gain, loss and deduction with respect to such asset shall take account of any variation between the adjusted basis of such asset for federal income tax purposes and its Gross Asset Value in the same manner as under Code Section 704(c) and the Regulations thereunder.”

Detailed examples to be discussed in an upcoming webinar.

Questions????