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Capital Accounts in LLCs and in Partnerships: Powerful Default Rules and Potential Tax Significance

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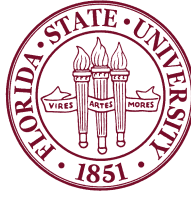
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BUSINESS REVIEW

Capital Accounts in LLCs and in Partnerships:
Powerful Default Rules and Potential Tax Significance

Donald J. Weidner

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Capital Accounts in LLCs and in Partnerships: Powerful Default Rules and Potential Tax Significance

Donald J. Weidner*

Abstract:

Balance sheets for limited liability companies and for partnerships differ from corporate balance sheets in one important respect. Accounting for these alternative forms traditionally includes a separate equity account, or “capital account,” for each owner. Accounting practice and caselaw suggest that, at least as a default rule or norm, these accounts guide distributions on liquidation or buyout, and, if negative, may also reflect debts to the firm. Indeed, the statutory default rule of partnership law in most states requires that individual capital accounts be maintained and given economic significance on liquidation or buyout. Although the statutory law of LLCs does not contain these default rules, partnership law provides analogy. Furthermore, the federal income tax rules that apply both to partnerships and to most multi-member LLCs closely examine the maintenance and significance of capital accounts to determine the validity of special allocations of tax benefits. Finally, capital accounts analysis also sharpens the understanding of the economic arrangement of the owners, particularly with respect to how and to what extent they have agreed to share different items of loss.

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I. INTRODUCTION

A lawyer drafting either an operating agreement for a limited liability company or a partnership agreement will be attempting to

tease out, and reduce to writing, the basic economic understanding of the co-owners. Core matters include: the contributions each owner will make; how much credit each will be given for those contributions, be they of property or of services; how the owners will share in profits; how they will share in losses; how they will share in operating distributions; the price to be paid in the event of a buy-out; the right to any liquidating distributions; and the right to require another owner to “pony up” a final amount on liquidation or buyout.¹

Dealing with the client can be sensitive, particularly when it comes to reducing to writing exactly what happens if things do not go as well as expected. Sometimes consciously and sometimes unconsciously, the drafter also will be interacting with: 1. the organization’s accountant, who may not yet be identified but who is likely to create a separate “capital account” for each owner; 2. statutory default rules that may give economic significance to those capital accounts; and 3. provisions of standard form agreements that contain impenetrable language designed to assuage federal income tax authorities who, in an audit, are likely to scrutinize the significance of capital accounts to determine the propriety of special allocations of tax benefits.

The purpose of this Article is to provide an integrated view of capital accounts in LLCs and in partnerships. It begins with an explanation of what capital accounts are and what they are not. It emphasizes their importance as a matter of accounting practice and as a matter of state law. It also attempts to put their federal income tax significance into simple historical perspective. It assumes that the economic understanding of the parties must drive the maintenance of capital accounts and cautions that the adoption of standard form tax boilerplate may frustrate that understanding. Because of the opportunities the federal income tax law offers to these “pass-through” organizations, there are often two sets of books, one for financial accounting purposes and one for federal income tax purposes.² For simplicity of analysis, this Chapter proceeds on the assumption that they are one and the same.

1. Other core economic matters include: whether there is a right to make capital calls and remedies for failing to heed the call; who has the right to compel operating distributions; provisions concerning organizational continuity, such as the right or obligation to be bought out and the right to liquidate the business; and any waivers of the obligation to refrain from competing.

2. See generally *Frank Lyon Co. v. United States*, 435 U.S. 561, 577 (1978) (“[T]he characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same.”). See also *Thor Power Tool Co. v. Comm’r*, 439 U.S. 522, 542 (1971) referring to “the vastly different objectives that financial and tax accounting have.”

II. THE BALANCE SHEET AND CAPITAL ACCOUNTS

Most generally, the accounting profession will apply basic accounting principles to represent the economic understanding of firm owners. The application of these basic principles will produce at least two basic documents: an income and expense statement and a balance sheet. Even the generalist is likely to recall that the balance sheet reflects the age-old equation: $\text{Assets} = \text{Liabilities} + \text{Equity}$. In the case of both the LLC and the partnership, each member or partner has a specifically designated share of the equity portion of the balance sheet.³ The owner's separate share of the organizational equity, or of the overall "owner's equity," is referred to as that owner's "capital account." This is very different from accounting for corporations, in which shareholders are not given individual equity accounts.

Consider, for example, the situation of a partnership or LLC in which owners A and B contribute \$6 and \$4, respectively. The double entry system of accounting will reflect where the money came from, that is, from contributions of capital, and where it went, initially into the organization's assets, that is, cash. Assume that the firm then borrows \$90 in cash and uses the total \$100 cash on hand to purchase a piece of real property. The balance sheet will show, on the left side, a real property asset at its \$100 cost and, on the right side, \$90 in the liabilities section of the balance sheet and \$10 in capital accounts, with A's capital account reflecting A's \$6 contribution and B's capital account reflecting B's \$4 contribution.

At the most elemental level, then, each owner's capital account reflects how much the owner has a right to receive from firm equity. Thus, if the \$100 asset were subsequently sold for a price equal to its acquisition cost, and the liability were repaid for \$90, the asset side of the balance sheet would show \$10 in assets and the capital accounts would say that, if the firm were liquidated, A would receive \$6 and B would receive \$4.

Restated for our present purposes, each owner has an individual capital account that reflects that owner's share of firm assets minus their share of firm liabilities. The capital account is often described, sometimes loosely and inaccurately, as the owner's "bank account" in the organization. Like a usual bank account, one's capital account may be positive (thus reflecting, at some very general level, at least the hope of a distribution) or negative (overdrawn, and thus, also at some very general level, reflecting an obligation to pay back). Unlike

3. For the sake of simplicity, members of LLCs and partners in partnerships will both be referred to as "owners."

the usual bank account, however, the maintenance of owners' capital accounts is much more complicated and varied, even before taking into account its significance either for state law purposes or for federal income tax purposes.

III. BASIC CAPITAL ACCOUNT ACCOUNTING

A. *The Primacy of Intent*

The basic rule of both LLC law and partnership law is that the owners are free to allocate each of the economic consequences of their business as they see fit (provided they do not violate the rights of third parties). As among themselves, for example, they are free to agree: on how much credit they are to be given for different kinds of contributions; on how they share profits, or different kinds of profits; on how they share losses, or different kinds of losses; on when and how they receive operating, or current, distributions; and on their rights and duties when one of them is bought out or on liquidation of the business. The task of the agreement is to record these decisions. The task of the accountant is to execute the agreement on the organizational books. Sometimes, however, the written agreement may be incomplete, ambiguous or vague. Because the capital accounts reflect the sharing relationships among the owners, an accountant is likely to be filling in the gaps along the way. In filling those gaps, the accountant may be informed by a wide variety of factors, including practices of the various members, conversations with them, personal experience with them in other contexts, standard practice in the business or industry, and local statutory or decisional law. At least annually, the documents will be produced. Because of this, financial statements may be considered as evidence of the agreement of the owners.

B. *Capital Account "Maintenance"*

1. What Capital Accounts Are and Are Not: Equity Accounts that Mix Apples and Oranges

Because of the popularity and at least relative appropriateness of the analogy to a bank account, it is important to explain why a capital account is *not* like a normal bank account. The stereotypical bank account is a record of transactions in hard cash, increased both

by dollars deposited and by interest credited and decreased by withdrawals.⁴ The classic bank account does not involve any judgment calls estimating, through appraisal or otherwise, the value of assets. Although capital accounts could be similarly constructed and maintained, they rarely are. They usually reflect a mix of hard cash entries and entries that involve estimates of the value assigned to assets or, on occasion, to services. Often, and not necessarily on a regular basis, assets that are initially listed at one value are revalued, or “marked to market.”⁵ Consider some of the things usually in the mix.

a. Cash.

Hard dollar entries typically include cash contributions and loan amounts. A cash contribution of \$100 will be reflected as a \$100 asset, and it will be credited to the capital account of the owner who contributed it. A loan of \$100 in cash will be reflected as a \$100 cash asset and also will be reflected as a \$100 liability on the other side of the balance sheet, with no effect on the owners’ capital accounts. Conversely, if \$50 is transferred to an owner as a distribution, the asset account will be reduced by \$50 and the recipient owner’s capital account will also be reduced by \$50.

Capital accounts do *not* reflect all cash transfers to and from owners. Most broadly and most importantly, capital accounts only reflect an owner’s equity in the venture and transactions with regard to that owner’s equity.⁶ An owner’s capital account does *not* reflect a transaction in which the owner is interacting with the firm as if the owner were an unrelated third party—sometimes referred to as a “third party” transaction.⁷ Thus, in the simple situation under discussion, if the \$50 in cash is transferred to the owner as a salary rather than as a distribution of owner’s equity, it will *not* reduce the recipient’s capital account.

4. Until the recent financial crisis, there was little suggestion that bank accounts would ever be reduced by “negative interest.”

5. Howard E. Abrams, *Partnership Book-Ups*, 127 TAX NOTES 435, 436 (April 26, 2010), available at http://papers.ssrn.com/sol3papers.cfm?abstract_id=1652569.

6. Donald H. Baker, *What Does That Operating Agreement Mean? A Primer on LLC Capital Accounting for the Non-Specialist*, MICH. BUS. L.J., Summer 2010, at 13, 13.

7. Joni Larson, PARTNERSHIP TAXATION: AN APPLICATION APPROACH 373-75 (Carolina Academic Press, 2d ed., 2013). I.R.C. § 707(a)(1) (2012) sets out the general rule that if an owner “engages in a transaction with a [firm] other than in his capacity as an [owner] of such [firm], the transaction shall, except as otherwise provided in this section, be considered as occurring between the [firm] and one who is not [an owner].”

b. Noncash Assets and Transfers.

If \$200 in firm cash is used to purchase an asset, the \$200 in cash will disappear from the firm books and the new asset will be listed at its \$200 cost. The liability account and the capital accounts will remain unchanged. On the other hand, if an asset that was purchased long ago outside the firm is transferred to the firm by an owner through a contribution of capital, the asset is likely to be listed on the firm's books at an estimate of its current value rather than at its historical cost.⁸ If, for example, owner X contributes to firm capital an automobile that X purchased years ago for \$1,000, the owners may agree it is now worth only \$200 and reflect that estimate on the firm books. Thus, the automobile will be listed as a \$200 asset and X will receive a credit of only \$200 to capital account. The balance sheet will balance.

Here again, capital accounts do *not* reflect all transfers of non-cash assets between the owners and the firm. Capital accounts only reflect an owner's equity and transactions with regard to that equity. Thus, if in the above example X sells the property to the firm rather than transfers it as a contribution to capital, the sale will not affect X's capital account.

Assets listed on a balance sheet are often charged with estimated depreciation. The depreciation for financial accounting purposes may be chosen as the best possible estimate of economic depreciation. Or, management may decide to overstate or understate economic depreciation on the firm books. For example, the asset could, as an economic matter, be appreciating significantly and still be "charged" with depreciation that is being claimed for financial accounting purposes, federal income tax purposes, or both.⁹

If an asset is reduced by a \$100 depreciation charge, you will not be surprised to learn that the balance sheet will be made to balance. On the other side of the balance sheet, liabilities will not be reduced by the depreciation charge and that leaves only the capital accounts, which must, in the aggregate, be reduced by a total amount equal to the depreciation charge. Someone must decide how that depreciation charge is allocated among the owners' capital accounts. For example, will a portion of it reduce the capital accounts of each of the owners or will it all be charged to reduce the capital account of the

8. Daniel L. Simmons, *Built-in Gain and Built-in Loss Property on Formation of a Partnership: An Exploration of the Grand Elegance of Partnership Capital Accounts*, 9 FLA. TAX REV. 599, 603-10 (2009). I.R.C. § 704(c) (2012) and the regulations thereunder address the appropriate tax allocations when property is contributed to a firm at a value different than its basis, that is, with a "built-in" gain or loss.

9. Federal income tax law restricts the methods taxpayers may use to compute tax depreciation. See I.R.C. §§ 167, 168, 197 (2012).

owner who contributed the asset? If all owners are to share in the charge, by how much will each owner's capital account be reduced? These are questions that should be answered in the agreement. If the agreement is silent, statutory default rules, to be discussed shortly, may be called upon to answer the question. As we shall see, the Internal Revenue Service may closely examine the impact of allocations of tax depreciation on capital accounts, and on the significance given to those accounts, to determine the validity of the allocations for federal income tax purposes.

Finally, depreciation deductions aside, an asset listed at one amount can subsequently be listed at a different, or restated, amount. According to popular terminology, an asset may be "marked to market." That process may entail a marking up or a marking down. For example, if a firm purchases a share of stock for \$100, it is likely to be listed on the balance sheet at \$100. If the stock is regularly traded and has tripled in value, it may be "marked up" on the balance sheet to its \$300 market value. Because the balance sheet must balance and liabilities remain unaffected, the capital accounts of the owners must be increased to reflect the additional \$200 in equity. Here again, the operating or partnership agreement should answer the question how that \$200 in unrealized profit should be allocated among the owners. The same issues are presented if the asset drops in value.

c. Services.

Services contributed by an owner are not usually assigned a value for financial accounting purposes. Therefore, the value of those services will not be reflected on the balance sheet as affecting assets, liabilities or capital accounts. As we shall see, this difference in treatment from cash contributions can have unpleasant consequences for the owner who contributes services, *especially* if capital accounts are treated as bank accounts. On the other hand, the owners could conclude that an owner contributing services should indeed get a credit for the value of those services. If those services appear, for example, as a \$400 asset on the firm books, perhaps described as "good will" or as "prepaid services," the balance sheet will be made to balance. The owner contributing services deemed to be worth \$400 will receive a \$400 credit to his, her or its capital account. Although "nothing prohibits" assigning a value to an owner's intangible contribution and listing it as an asset called "goodwill,"

the practice poses “definite theoretical problems” from an accounting perspective.¹⁰ It can be problematic to list an asset when “no funds have been spent.”¹¹

In short, an owner’s capital account is the owner’s share of the organization’s net apples and oranges. The lawyer’s job, at a minimum, is to tease out and memorialize in an agreement the intent of the owners with regard to how they will slice and dice those apples and oranges among themselves. The accounting profession will then apply the agreement to the results of operation of the business. It will produce constantly changing capital accounts that capture the cumulative impact of operations on the equity account of each owner. These individualized owner’s equity accounts represent a whole additional level of accounting that does not exist on a corporate balance sheet, which does not assign shareholders their individual slices of firm equity. One way of thinking about it is by considering that standard corporate accounting reflects an entity approach whereas standard LLC and partnership accounting reflects an aggregate approach.

2. The Maintenance Rules in a Nutshell

The basic rules of capital account maintenance can be stated simply. On the positive side, an owner’s capital account is increased, or credited, by the cash and by the agreed net value of any property the owner contributes.¹² It is also increased by the owner’s share of any firm profits.¹³ On the negative side, an owner’s capital account is decreased, or debited, by the amount of cash and by the net value of any property the owner receives as a distribution.¹⁴ It is also decreased by any depreciation charged to the owner and by the owner’s share of any other losses.¹⁵

The owners may not think about their capital accounts until one or more of them leaves or until the firm is liquidated. At either one of those points, the intent of the owners, ideally reflected in their agreement, is of course the ultimate driver. The intent of the owners may be to carve up the equity pie in specific ways completely independent of capital accounts. On the other hand, the owners’ agreement may specifically provide that capital accounts determine, for

10. Joe Ben Hoyle, Thomas F. Schaefer & Timothy S. Douppnik, FUNDAMENTALS OF ADVANCED ACCOUNTING 415 (McGraw-Hill/Irwin eds., 4th ed., 2010).

11. “Thus, although partnership goodwill is sometimes encountered in actual practice, this ‘asset’ should be viewed with a strong degree of professional skepticism.” *Id.*

12. *See* RUPA § 401(a)(1).

13. *Id.*

14. *Id.* § 401(a)(2).

15. *Id.* Although RUPA does not expressly refer to depreciation, the balance sheet equation requires that depreciation reduce capital.

example, the amount of a buyout price or the allocation of liquidating distributions. The most difficult situations to deal with are those in which the owners' agreement is ambiguous, vague, silent on the point, or completely nonexistent. In those situations, the capital accounts may be deemed to be the best evidence of their agreement.

Capital accounts can have two different kinds of economic consequences. First, the owner's positive capital accounts may direct the distribution of the net assets that remain in the firm.¹⁶ Second, an owner's negative capital account may be deemed to reflect a debt to the firm that the owner must repay to the firm.¹⁷ The amount repaid to the firm would then either be paid to firm creditors or distributed to owners with positive capital account balances. Not all owners may have intended giving either or both of these kinds of significance to capital accounts. The owners are of course free to give the capital accounts whatever economic significance they choose. The problem is that they may never even have thought about the matter.

3. Misunderstandings and Unintended Consequences

There are two basic aspects of normal capital account maintenance that often either cause or reflect unintended consequences. The first is that a negative capital account may be regarded as reflecting a debt to the firm, which can come as a shock to an owner who contributes services. The second is that there will be a need to mark assets to market before capital accounts can be given their "normal" significance upon either a liquidation or a buyout.

a. Negative Account Shock to Service Partner.

Consider again the often oversimplified statement that a capital account can be analogized to a bank account. The statement persists because there is some truth to it. Viewed as a bank account, a negative capital account is like an overdrawn bank account—there is an obligation to repay the firm. The question is whether that obligation is nonrecourse or recourse.

16. See RUPA § 807(a).

17. As explained more fully below, the default rule that is in RUPA Section 807(b) is that a negative capital account reflects a debt to the partnership that must be repaid either upon liquidation or upon buyout. However, the "deficit makeup" requirement was found under accounting practice and under state law well before RUPA. In *Park Cities Corp. v. Byrd*, 534 S.W.2d 668 (Tex. 1976), a \$2 million deficit in a general partner's capital account was held to reflect a debt to her partnership, even though her capital account was rendered negative by special allocations of what the court referred to as "depreciation losses" and not by cash withdrawals.

Consider the situation of a complete liquidation of the business. Capital accounts can have the two basic functions alluded to earlier. First, they can direct the distribution of any net equity that remains in the firm after the business has been wound down and outsider creditors have been satisfied. Second, they can reflect that an owner with a negative capital account has an obligation to contribute additional assets to the firm so that those fresh assets can be distributed to unsatisfied firm creditors or to other owners.

Consider the example of an extremely simple liquidation of a two-person firm. Assume that all the firm's assets have been sold and reduced to cash. Assume that cash has then been used to satisfy all the firm's outside creditors. Although there are no remaining assets inside the firm, and no remaining liabilities to third parties, the two owners of the firm are left with "opposite-signed" capital accounts. That is to say, one owner has a positive capital account and the other has a negative capital account. Because the balance sheet must balance, if there are no remaining assets or third-party liabilities, one capital account will be negative in the same amount as the other capital account is positive.

Putting some meat on the bones of this example, assume that, after all assets have been liquidated and the proceeds paid to satisfy creditors, the firm is an empty shell that reports owner A with a positive capital account of \$100 and owner B with a negative capital account of \$100. The normal application of capital accounts analysis provides that B must contribute \$100 to the firm to bring B's capital account up from minus \$100 to zero.¹⁸ The balance sheet must still balance, and the new cash asset of \$100 would be attributed to A's \$100 positive capital account. As a result, A would receive a liquidating distribution of that \$100. After that distribution, the balance sheet would continue to balance, with zero assets, zero liabilities and two zero capital accounts. As we shall see, this is the result of the default capital account reconciliation rules in the Revised Uniform Partnership Act. In short, these rules give the capital accounts both kinds of significance. They guide the distribution of what is in the firm at liquidation. They also require that a negative capital account be treated as reflecting a recourse obligation to pay more money into the firm.¹⁹

The classic and most controversial situation in which opposite-signed capital accounts can have unexpected consequences involves a mixture of owners who contribute services and owners who contribute capital. Consider a hypothetical two-person firm made up of

18. See *supra* text accompanying note 15.

19. The rules make an exception in the case of a negative capital account of a limited liability partner.

one owner, Property, who contributes property and another owner, Services, who contributes services. If Property pays \$100 for property and contributes it to the firm, the balance sheet will balance. The contribution of the \$100 piece of property is reflected on the firm books both as a \$100 property asset and as a \$100 credit to Property's capital account on the other side of the balance sheet. Unless otherwise agreed, Services will not be treated as contributing an asset and hence will not receive any credit to Services' capital account. Assume that nothing else happens except that the property is subsequently sold for only \$20, that is, at an \$80 loss. The question is how that loss will be shared. If Property and Services have agreed to share all losses equally, the \$80 loss will be charged 50/50 to their respective capital accounts. The result is that there will be \$20 cash left in the firm. The equal sharing of the \$80 loss will reduce Property's capital account from \$100 to \$60 and Services' capital account from zero to negative \$40, or (\$40).

Make no mistake about it, two things are clear. First, the analogy to bank accounts and the default rules in the case of partnerships both say that Services must contribute \$40, thus bringing Services' capital account from (\$40) up to zero and the total firm cash up from \$20 to \$60. The \$60 is then distributed to liquidate the equity interest of Property, taking Property's capital account from \$60 to zero. After the distribution, the balance sheet balances. Zero assets on one side of the balance sheet equals the sum of zero liabilities and zero capital accounts on the other side.

The second thing that is clear is that this may come as a complete surprise to Services. Services may not have understood that the general agreement to share losses equally applied to losses from the sale of property contributed by Property. The fundamental problem, if there is one, is not with capital accounts or their analysis. The fundamental problem is that the owners may never have reached a common understanding of the meaning of the agreement that all losses will be shared equally.

b. Confusion Regarding Impact on Current versus Liquidating Distributions and on Buyouts.

There is a second, more general way in which capital accounts maintenance, and the analogy to a bank account, can lead to misunderstanding. We have seen that a failure to understand that capital accounts represent a mix of apples and oranges can lead to the inaccurate assumption that an owner's capital account represents a reasonably accurate snapshot of the value of the owner's equity.

This basic misunderstanding can lead to the further mistaken assumption that capital accounts have equal predictive value, if not mandatory force, in the case of a current distribution, in the case of a liquidating distribution, and in the case of a buyout.

Capital accounts generally have different consequences in each of these three situations. Capital accounts do not mandate when current distributions must be made. Nor do they determine when additional contributions must be made. They are much more immediately determinative in the case of a liquidation and in the case of a buyout. In either event, unlike the normal bank account, the assets must be restated to bring capital accounts up or down to their current economic significance. In the case of a liquidation, the value of the assets, and hence of the capital accounts, will be determined by a sale. In the case of a buyout, the value of the assets, and hence of capital accounts, must be determined by appraisal.

i. Current Distributions.

It is important to emphasize that capital accounts say very little about the right to a current distribution. Even if a capital account accurately reflects the value of an owner's equity to the penny, it does not say anything about the right to receive a current distribution. Indeed, even if the firm's only asset is cash, the capital accounts do not even suggest that the holder of a positive capital account has any right to a current distribution. Such a right, if it exists, must be found in the agreement of the owners, which may be in writing or may be established in parol. As we are about to see, statutory default rules, both for partnerships and for LLCs, are notably silent on the basic issue of when an owner has a right to a current distribution. Much to the chagrin of the creditors of owners, capital accounts, standing alone, do not fill the void. An owner's creditors cannot levy upon a right the owner does not have.

ii. Liquidations and Buyouts.

Capital accounts, subject always to the agreement of the owners, have more to say when an owner exits the firm. Indeed, they may be all-important. Owner exit can be effected in one of two ways. First, the owner can be "cashed out" as part of a liquidation of the firm. Most simply, liquidation can be accomplished either by sale of the entire business as a going concern or by selling the firm's assets and satisfying its liabilities. The sale will determine the value of firm assets and profit or loss will be charged to capital accounts, which can in turn reflect who gets distributions and whether anyone is required to make up a deficit. Second, the owner could be simply

“bought out” of a firm that will continue. In this case, a hypothetical sale of firm assets will determine profit or loss to be allocated among owners. The allocation of losses may mean that the person being bought out may be required to pay a deficit rather than receive anything.²⁰ As always, in both these situations, the partnership or operating agreement controls the rights among the owners and between the owners and the firm. However, unlike the situation involving a current distribution, in the case of a liquidation or buyout, if the agreement is not clear, statutory default rules may give the capital accounts great economic significance. It is to these rules that we now turn.

IV. STATUTORY DEFAULT RULES ON CAPITAL ACCOUNTS

A. Partnerships

Partnership law is more detailed regarding the maintenance and significance of capital accounts than is the law of LLCs in most states. Most states have adopted the Revised Uniform Partnership Act of 1994 (“RUPA”)²¹ and many of the subsequent amendments to it. RUPA introduced extensive default rules on the relations among partners and between partnerships and partners that were unprecedented in scope.²² In particular, RUPA introduced default rules that “deem” capital accounts to be maintained for each partner and give those capital accounts important economic significance when a partnership is being liquidated and when a departing partner is being bought out.

1. RUPA’s Capital Account Maintenance Rules

RUPA makes clear that its capital account rules are all default rules, rather than mandatory rules. That is, as among themselves, the partners’ agreement controls.²³ The partners are free to agree to give capital accounts any significance they like, or none at all.

If the partnership agreement is silent on the point, RUPA deems that capital accounts are maintained in a certain way.

20. See discussion *infra* Part IV.A.3.

21. In 1996, RUPA was modified to include limited liability partnership provisions. UNIF. P’SHIP ACT, 6 U.L.A. Part I (1997) (hereinafter “RUPA”). The Uniform Law Commission, which promulgated the RUPA in 1994 and its 1997 revision, has recently approved “harmonized” provisions that eliminate the capital account provisions that most states have adopted as part of RUPA.

22. See generally Allan Donn, Robert W. Hillman & Donald J. Weidner, *THE REVISED UNIFORM PARTNERSHIP ACT* (Thompson West 2014).

23. RUPA § 103(a) (2014).

Each partner is deemed to have an account that is:

(1) credited with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, the partner contributes to the partnership and the partner's share of the partnership profits; and

(2) charged with an amount equal to the money plus the value of any other property, net of the amount of any liabilities, distributed by the partnership to the partner and the partner's share of the partnership losses.²⁴

These rules do not provide for crediting a capital account for a contribution of services. Accompanying default rules provide how much of the firm's profits or losses are to be credited or charged to each partner. Profits are to be shared and credited equally and losses are to be shared and charged "in proportion to the partner's share of the profits."²⁵ The Official Comments to these unprecedented provisions are brief but make four basic points.

First, the Official Comments explain that RUPA's capital account maintenance rules reflect the basic accounting practice described earlier in this chapter. This is an important point to be made in response to those who believe that RUPA's new provisions on capital accounts are inappropriate. RUPA's rules on capital accounts reflect what is taking place in the world of business, particularly small business. More precisely, even if the partners in their agreement do not specifically agree to construct and maintain a capital account for each partner, the accounting profession is likely to do it as a matter of course. The partners, or their attorneys, may not be aware of that. Furthermore, they may not be aware that proper capital account creation and maintenance may be critical if the Internal Revenue Service challenges the validity of special allocations of tax benefits among the partners.

Second, the Official Comments underscore that RUPA's capital account rules are default rules rather than mandatory rules.²⁶ As is almost always the case with RUPA's rules regulating the rights among partners, and the rules between partnership and partners, RUPA's capital account rules can be set aside by the agreement of the partners. In the language of the Official Comments, RUPA's capital account rules apply only "[i]n the absence of another system of

24. *Id.* § 401(a) (2014).

25. *Id.* § 401(b) (2014).

26. *Id.* § 103 (2014).

partnership accounts” chosen by the partners.²⁷ Sophisticated parties, or unsophisticated parties, can craft economic agreements among themselves as they see fit, provided the rights of third parties are not violated.

Third, the Official Comments acknowledge that RUPA’s capital account rules are “rudimentary.”²⁸ Why enact statutory default rules that simply scratch the surface of sophisticated business practice? As the Reporter on the project, I can write with confidence that the Drafting Committee concluded that some guidance was better than none at all. The fundamental reason for including “rudimentary” rules on the construction and maintenance of capital accounts is to give an analytical starting point to small business people, to their lawyers and other advisors, and to the judges or mediators who might be resolving their disputes. The core function of RUPA is, after all, to provide a “residual” set of rules to govern unincorporated businesses. That is, RUPA controls co-owners of a business for profit who have not formed any other business organization. It is a package of clear and predictable rules for the participants, and for the resolvers of their disputes, to turn to when they have no provable agreement. In particular, RUPA’s capital account rules tell all involved how to begin to analyze who gets what in the event of commercial divorce.

Finally, reflecting the importance of capital accounts in the event of commercial divorce, the Official Comments direct the reader to the provisions on partnership liquidations, in which the capital accounts are given their most direct and explicit significance.²⁹ As we shall see, these capital accounts-driven liquidation rules are in turn the starting point for the default rule on the price that must be paid to buy a partner out.³⁰

2. Impact on Liquidating Distributions: The Capital Account Reconciliation Requirement

RUPA gives the most direct significance to capital accounts in the case of a liquidation of the partnership. The key provision is Section 807, which is entitled “Settlement of Accounts and Contributions Among Partners.” It provides that the firm assets “must be applied to discharge its obligations to creditors” and that “[a]ny surplus must be

27. *Id.* § 401 cmt. 2 (2014).

28. Indeed, they are so rudimentary they include no reference to a charge for depreciation.

29. “The rules regarding the settlement of the partners’ accounts upon the dissolution and winding up of the partnership business are found in Section 807.” RUPA § 401 cmt. 2 (2014).

30. See *infra* Section IV (A)(3), Significance on Buyout, especially the discussion of *R4 Properties v. Riffice*.

applied to pay in cash the net amount distributable to partners in accordance with their right to distributions” under RUPA’s capital account reconciliation rule. This “in cash rule” means that, in the case of a liquidation of the business, a “mark to market” approach is not sufficient. Unless the partners have agreed to the contrary, any partner has the right to insist that the assets be sold and the proceeds used to satisfy creditors. No partner may either insist upon or be forced to accept a liquidating distribution in any form other than cash.³¹

What happens after the assets are sold? Section 807’s capital account reconciliation rule first provides that the profits and losses “from the liquidation of the partnership assets must be credited and charged to the partners’ accounts.”³² It then gives the capital accounts both kinds of significance discussed earlier. First, the capital accounts guide the liquidating distribution of any cash that remains after creditors are satisfied: “The partnership shall make a distribution to a partner in an amount equal to any excess of the credits over the charges in the partner’s account.”³³ Second, a negative capital account must be treated as reflecting a debt to the partnership. In the statutory language: each partner “shall contribute to the partnership an amount equal to any excess of the charges over the credits in the partner’s account.”³⁴ All of this makes sense under standard accounting practice. Because the balance sheet will always be in balance, one partner’s negative capital account means that there is an “opposite signed” amount somewhere else. The negative capital account of Partner A means either that one of the other partners has a positive capital account or that there is an outstanding liability to a creditor. Thus, the additional money contributed by the partner with the negative capital account will either be paid out to an unsatisfied creditor or be distributed to another partner with a positive capital account balance.

3. Significance on Buyout

RUPA also contains default provisions of unprecedented detail defining what happens when a partner is to be bought out of a partnership that will continue. Among other things, and most importantly for our purposes, it defines the price that must be paid to the partner being bought out. In the case of a buyout, the basic price

31. RUPA § 402 (2014) provides: “A partner has no right to receive, and may not be required to accept, a distribution in kind.”

32. *Id.* § 807(b) (2014).

33. *Id.*

34. *Id.* The deficit makeup calculation does not include “charges attributable to an obligation for which the partner is not personally liable under” the limited liability partnership shield of RUPA § 306(c). *Id.*

that must be paid is the amount the partner being bought out would have received if the partnership were being liquidated.³⁵ Stated differently, the buyout price is theoretically determined by a hypothetical liquidation of the business. Hence, Section 807's capital account reconciliation rule must be applied, although in a modified way. Because the partnership assets are not being sold as they would be in the case of a "true" liquidation, they must be valued--they must be "marked to market." As in the case of a liquidating distribution, when the reconciliation rule requires gain or loss on the sale of partnership assets to be credited or charged to capital accounts, gain or loss on the hypothetical sale of those same assets must also be reflected in capital accounts. Liabilities must then be hypothetically satisfied. The result is a hypothetical balance in the capital account of the partner being bought out.

The leading case on the significance of capital accounts in the event of a buyout is the very recent *R4 Properties v. Riffice*, which contains an excellent discussion of the capital account reconciliation rules.³⁶ A real estate partnership consisting of two couples was to continue until the partnership's property was sold.³⁷ One couple violated the partnership agreement by unilaterally declaring that they were dissociating immediately.³⁸ Because they departed prematurely, their dissociation did not cause a dissolution of the partnership under RUPA. Rather, the partnership continued without them.³⁹ The crux of the case was how RUPA's buyout rules apply to the negative capital accounts of a wrongfully dissociating partner.⁴⁰

The court affirmed the interpretation discussed above that the buyout rules require the dissociating partner to make up any deficit in capital account, just as if there had been a liquidating distribution.⁴¹ However, the wrongfully dissociating partners said that the buyout rules do not address the case in which the departing partners have negative capital accounts.⁴² They stressed that the buyout rules speak only of payments *to* the dissociating partner and say nothing about payments *from* the dissociating partner, much less payments to make up negative capital accounts.⁴³

The court said it would be "illogical" to say that the buyout price would be the dissociating partners' share of the value of any assets

35. *Id.* § 701(b) (2014). For further discussion of this provision, see RUPA § 701, authors' cmt. 4 (2014).

36. No. 3:09-cv-00400(DJS), 2014 WL 4724860 (D. Conn. Sept. 23, 2014).

37. *Id.* at *1.

38. *Id.* at *2.

39. *Id.* at *3.

40. *Id.* at *7.

41. *Id.* at *9.

42. *Id.* at *7.

43. *Id.*

without taking into account their share of any liabilities.⁴⁴ It also rejected the dissociating partners' argument that, if they were required to pay to a deficit makeup, they were not were required to pay it until the partnership properties were sold.⁴⁵ Under the buy-out rules, a partnership for a term is not required to pay the buyout price to the prematurely departing partner until the term ends.⁴⁶ The court said that the deferred payment rule was designed to protect the partnership from financial burden⁴⁷ and refused to allow the wrongfully dissociating partners to rely on that rule to postpone their obligation to restore the deficits in their capital accounts.⁴⁸ Since the partnership was not to be liquidated until at some point in the future, the hypothetical liquidation and capital account reconciliation would require an appraisal of partnership assets.⁴⁹

4. Significance on Current Distribution

RUPA's capital account maintenance and reconciliation rules were not intended to have any effect either on the right to receive a current distribution or on any current obligation to make an additional contribution.

B. Limited Liability Companies

The LLC acts in the various states were typically crafted by drafting committees made up of corporate lawyers more comfortable with the corporate form, and real estate, probate, and trust lawyers who were more comfortable with the partnership form. The resulting LLC acts draw both from partnership law and from corporate law. The state statutes vary greatly and in particular diverge based on how much, and what, they draw from each of the two pre-existing bodies of law. One thing is clear: most do *not* borrow heavily from RUPA's capital account maintenance and reconciliation rules.

44. The deficit makeup requirement on "buyout" is not limited to RUPA states. *RA Properties* cited and discussed with approval *Wassenaar v. Simons*, 16 F. App'x 274, 278 (4th Cir. 2001), which applied Virginia's non-RUPA partnership statute:

[R]equiring the [dissociating partner] to pay the negative net value of his partnership interest avoids the illogical result that would flow from [his] reading of [the partnership statute] whereby he, as an ousted partner, could collect his share of any positive value in the partnership, while at the same time standing immune from contribution for his share of the partnership's liabilities.

45. *Id.* at 10.

46. RUPA § 701(h).

47. The only exception to the deferred payment rule is if the dissociating partner can establish that earlier payment "will not cause undue hardship to the business of the partnership." *Id.*

48. *RA Properties*, 2014 WL 4724860, at *11.

49. *Id.* at *8.

1. The Revised Uniform Limited Liability Company Act

The Uniform Law Commission, which promulgated RUPA, subsequently promulgated the Revised Uniform Limited Liability Company Act (“RULLCA”).⁵⁰ The RULLCA has not been adopted nearly as widely as RUPA. However, it is instructive for the purpose of our focus on capital accounts. Although RULLCA borrows liberally from RUPA in other respects, it rejects RUPA’s treatment of capital accounts.⁵¹ It does so in a provision that addresses something that RUPA does not: the right to share in a current distribution. RUPA did not contain a separate provision on the right to current, or non-liquidating, distributions. Indeed, RUPA had no provision at all on current distributions. It is interesting that, to address something that RUPA did not, the RULLCA drafters felt it necessary to scrap all of RUPA’s capital accounts rules affecting liquidating distributions and buyouts.

The RULLCA rule on current distributions is a free-standing provision, Section 404, entitled “Sharing of and Right to Distributions before Dissolution.” It provides that a member has a right to a distribution before dissolution “only if the company decides to make an interim distribution.”⁵² However, if a distribution is made, it “must be in equal shares among members.”⁵³ In the process, RULLCA completely discards RUPA’s capital account reconciliation rules. The Official Comment to the current distribution rule explains the reason for eliminating “the default structure for maintaining capital accounts” as follows:

Capital accounts are maintained for one purpose, to determine how distributions will be made. . . . If the statute has a simple default rule for how distributions will be made to the members, providing an additional set of default profit and loss allocation provisions and capital account rules will be, at best, duplicative and, at worse, inconsistent with the distribution rules.⁵⁴

50. UNIF. LTD.LIAB. CO. ACT (2006) (amended 2011) (hereinafter “RULLCA”).

51. Indeed, a recent “harmonized” version of RUPA proposes to abandon the capital accounts rules. It remains to be seen whether this change will be widely adopted. Even if all statutory capital account default rules were to be eliminated, partnerships and LLCs would continue to generate capital accounts, absent a shift to a corporate approach that has no separate equity account for each owner.

52. RULLCA § 404(b) (2006).

53. *Id.* § 404(a): “Any distribution made by a limited liability company before its dissolution and winding up must be in equal shares among members and persons dissociated as members, except to the extent necessary to comply with a transfer effective under Section 502 or charging order in effect under Section 503.”

54. *Id.* § 404, cmt.1.

2. The Delaware Limited Liability Company Act

The Delaware LLC Act is probably the most influential statute governing LLCs. Here, as in many other cases, Delaware sets the standard for business law. Like RULLCA, the Delaware LLC Act declines to address the maintenance or significance of capital accounts.⁵⁵

V. FEDERAL INCOME TAX SIGNIFICANCE OF CAPITAL ACCOUNTS

As mentioned earlier, capital accounts can exist and be maintained entirely apart from federal income tax purposes. Here, as in other areas, two sets of books are often maintained, one for financial accounting purposes and the other for federal income tax purposes. The two sets of books can be quite different. For tax purposes, capital accounts must also include items of taxable income, gain, loss, deduction or credit allocated to the owners.

A. *Origin of Tax Rules on Capital Accounts that Bind Both Partnerships and LLCs*

Even though partnerships and LLCs are not bound by common state statutory default rules on the maintenance and significance of capital accounts, they continue to be linked both by common accounting practice and by the treatment they share for federal income tax purposes. For federal income tax purposes, most multi-member LLCs are “pass through” entities, just like partnerships.⁵⁶ Indeed, they are governed by the partnership tax rules of Subchapter K, the magic 700’s as I like to think of them, which enable an aggregate approach to taxation.⁵⁷ The LLC, being the newcomer on the block, simply got swept up into Subchapter K. Under these rules, there is no tax at the entity level. Rather, firm taxable income or loss, or items thereof, are “passed through” to the individual firm owners.⁵⁸ As a general rule, Subchapter K has historically given the owners great freedom to allocate items of income, gain, loss, deduction or credit among themselves as they see fit. If their so-called “special” allocations are “disregarded”

55. By contrast, Delaware’s partnership law includes RUPA’s capital account maintenance rule and RUPA’s capital account reconciliation rule. DEL. CODE ANN. tit. 6, §§ 15-401(g), 15-807(b) (2015).

56. A multi-member LLC may “check the box” and be treated as a corporation. I.R.C. § 7701 (2012); Treas. Reg. §§ 301.7701-2, 301.7701-3 (2014).

57. The entity approach continues for many purposes under Subchapter K. Most basically, the firm is a reporting entity.

58. I.R.C. § 701 (2012).

by the Internal Revenue Service (“IRS”), the IRS will reallocate them in a manner it deems more appropriate.⁵⁹

Rules on special allocations, also known as the “704(b)” rules because of the Internal Revenue Code section under which they were promulgated, were for years relatively brief.⁶⁰ In 1985, those rules were made much more complicated, and it may be useful to explain how they got that way. For many years prior to 1986, passive investors were being allocated hundreds of millions in tax losses from pass-through investments in which they took no active part and in amounts far beyond any amounts they had at risk. If investors made cash contributions, they were minor compared to the total amount of “basis” they were allowed to claim in their partnership interests. “Basis” is tax-speak for a taxpayer’s investment in the eyes of the tax law. In the heyday of real estate and other tax shelters, limited partners were claiming and using deductions up to the full amount of a basis that included not only the cash they contributed, and hence had at risk, but also their share of nonrecourse liabilities, with respect to which they took no risk.⁶¹ They were claiming “leveraged depreciation” and were being “specially allocated” items of deduction or loss in a way that the Treasury saw as significantly eroding the effectiveness of the personal income tax.⁶² “Investors” in real estate partnerships, for example, were sheltering from tax their income from other sources.⁶³

The Tax Reform Act of 1976 introduced “at risk” rules to limit deductions from certain investments to amounts taxpayers had at risk.⁶⁴ Amounts at risk included cash and recourse liabilities, but not nonrecourse liabilities. Nevertheless, these rules let a great deal through, and real estate tax shelters in particular continued to spread and grow. Ultimately, the “passive loss” rules, originally enacted in 1986, denied limited partners and other nonprofessional passive investors the ability to offset either their portfolio income or their personal service income with these partnership deductions.⁶⁵ Theoretically, they “get” their allocations of deduction or loss, they

59. I.R.C. § 704(b) (2012). The factors the IRS considers in this reallocation are: (a) The partners’ relative contributions to the partnership; (b) the interests of the partners in economic profits and losses (if different than that in taxable income or loss); (c) the interests of the partners in cash flow and other non-liquidating distributions; and (d) the rights of the partners to distributions of capital upon liquidation. Treas. Reg. § 1.704-1(b)(3)(ii).

60. Andrea Monroe, *Too Big to Fail: The Problem of Partnership Allocations*, 30 VA. TAX REV. 465, 522 (2010).

61. *E.g.* Estate of Franklin v. Comm’r, 544 F.2d 1045 (9th Cir. 1976) (limiting the utilization of such losses).

62. *E.g.*, Orrisch v. Comm’r, 55 T.C. 395 (1970).

63. *Id.*

64. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (current version codified at I.R.C. § 465 (2014)). These rules were strengthened in 1986.

65. Current version codified at I.R.C. § 469 (2014).

just can't use them. The passive loss rules went to the heart of the tax shelters and were a crowning victory for opponents of the limited partnership tax shelters that had spread from the top 1% deep into the middle class.⁶⁶

In 1983, three years before the passive loss rules were enacted, the IRS proposed dramatic amendments to the 704(b) regulations that were designed primarily to tighten down on tax shelters. Section 704(b) had itself been amended by the Tax Reform Act of 1976, which replaced 704(b)'s "principal purpose of . . . the avoidance or evasion of any tax" limitation with the current requirement that allocations have "substantial economic effect." The substantial economic effect language had previously appeared in the legislative history of the 1954 Code and in the regulations.⁶⁷ The 1983 proposals officially announced a shift to heavy reliance on capital accounts to probe, among other things, substantial economic effect. They also included extensive provisions on nonrecourse financing.⁶⁸ One wonders whether these 704(b) regulations, which were ultimately adopted and subsequently modified, would have been quite so complex⁶⁹ had they been drafted subsequent to the passage of the passive loss rules. Although special allocations continue to pose important issues, most of the war against pass-through tax shelters was won with the passive loss rules.⁷⁰

B. Section 704(b) and the Three Ways to Defend Tax Allocations Among Owners

Section 704(a) provides the general rule that owners are free to agree among themselves how they will share income gain, loss, deduction, or credit. The limitation in Section 704(b) is that an allocation they agree upon will be disregarded if it "does not have substantial economic effect."⁷¹ The item subject to the disregarded allocation will be reallocated "in accordance with the [owner's] interest in the

66. Mona L. Hymel, *Tax Policy and the Passive Loss Rules: Is Anybody Listening?*, 40 ARIZ. L. REV. 615, 617-18, 627-30 (1998).

67. Donald J. Weidner, *Partnership Allocations and Capital Accounts Analysis*, 42 OHIO ST. L.J. 467, 468 (1981).

68. *See generally* William S. McKee, William F. Nelson & Robert L. Whitmire, *FEDERAL TAXATION OF PARTNERSHIP AND PARTNERS* (Warren, Gorham & Lamont ed. 2014).

69. Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 545, 621 (1986) ("The new regulations under section 704(b) are a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become thoroughly prepared experts on the subject.")

70. Boris I. Bittker, Martin J. McMahon & Lawrence A. Zelenak, *A Whirlwind Tour of the Internal Revenue Code's At-Risk and Passive Activity Loss Rules*, 36 REAL PROP. PROB. & TR. J. 673, 684 (2002) ("As a result of Section 469, in particular the tax shelter industry it was known in the 1970's, and early 1980's has been closed almost completely.")

71. I.R.C. § 704(b)(2) (2014). As indicated above, the substantial economic effect language was added to the statute by the Tax Reform Act of 1976.

[firm] (determined by taking into account all facts and circumstances).”⁷² An owner’s “interest in the [firm]” is also the default rule for guiding the allocations of tax items that the members never agreed upon.⁷³ The terribly complex 704(b) regulations promulgated under these simple statutory rules place considerable emphasis on an analysis of the owners’ capital accounts.⁷⁴

Treasury Regulation Section 1.704-1(b) tells owners that an allocation they agree to may be justified, or respected, in one of three ways.⁷⁵ First, if the allocation has substantial economic effect, as that term is defined in the regulations. Second, if the allocation *is* in accordance with the owner’s interest in the firm, as that term is defined in the regulations. Third, if the allocation is *deemed* to be in accordance with an owner’s interest in the firm pursuant to one of the special rules contained in the regulations.⁷⁶

1. Substantial Economic Effect: Strict Capital Account Observance

In order for a firm’s allocation to have substantial economic effect, the regulations emphasize, there must be an economic effect and it must be substantial.⁷⁷ The “Fundamental principle” is that, in order for an allocation to have economic effect, it must be consistent with the economic arrangement of the owners. The basic policy judgment is clear:

[I]n the event there is an economic benefit or economic burden that corresponds to an allocation, the [owner] to whom the allocation is made must receive such economic benefit or bear such economic burden.⁷⁸

The regulations then set out a “safe harbor” that is based on satisfying three prongs of capital accounts analysis.

72. I.R.C. § 704(b) (2014) (flush language). The “interest in the [firm]” language was also added in 1976.

73. I.R.C. § 704(b)(1) (2014).

74. Monroe, *supra* note 60, at 478 (“As a matter of informal practice, capital accounts became increasingly important to the determination of whether allocations had substantial economic effect. If a partnership allocated its tax items in the same manner that the corresponding economic items were reflected in the partners’ capital accounts, then such tax allocations would have independent economic significance apart from their tax consequences. That is, the tax allocations would have substantial economic effect.”).

75. Technically, the 704(b) regulations only describe whether an allocation will be respected *as a matter of Section 704(b)*. They are explicit that overarching tax avoidance principles, or other specific provisions, may cause an allocation to be disregarded even if it is respected as a matter of 704(b). Treas. Reg. § 1.704-1(b)(i)(iii) (2015).

76. Treas. Reg. § 1.704-1(b)(1)(i) (2015).

77. Treas. Reg. § 1.704-1(b)(2)(i) (2015).

78. Treas. Reg. § 1.704-1(b)(2)(ii)(a) (2015).

a. Capital Accounts Must Be Properly Maintained.

Capital accounts must be maintained throughout the life of the firm in accordance with the capital account maintenance rules in the regulations. Those rules essentially require a basic capital account maintenance that also reflects tax allocations. That is, capital accounts must be maintained as described earlier in this chapter and also must reflect tax allocations of income, gain, loss, deduction, or credit.⁷⁹

b. Liquidating Distributions Must Be Made in Accordance with Positive Capital Account Balances.

Upon liquidation of the firm, or of an owner's interest in the firm, liquidating distributions must "in all cases . . . be made in accordance with the positive capital account balances" of the owners.⁸⁰

c. Negative Capital Accounts Must Be Treated as Debts to the Firm.

If liquidation of a member's interest results in a "deficit balance" (negative) capital account, the member must be "unconditionally obligated to restore the amount of such deficit balance" to the firm, "which amount shall, upon liquidation of the [firm], be paid to creditors of the [firm] or distributed to other [owners] in accordance with their positive capital account balances."⁸¹ As explained earlier, this is the same as RUPA's capital account reconciliation rule.

The regulations contain an alternative test for economic effect. The alternate test also engages basic capital accounts analysis. Under this test, as under the basic substantial economic effect test, capital accounts must be properly maintained and liquidation proceeds must be distributed in accordance with positive capital accounts balances. However, in lieu of requiring an owner to restore any capital account deficit, the firm may provide for a "qualified income offset." The basic idea is that an owner who unexpectedly receives certain allocations that drive the owner's capital account negative must be allocated offsetting allocations that drive the owner's capital account positive "in an amount and manner sufficient to eliminate such deficit balance as quickly as possible."⁸²

79. Treas. Reg. § 1.704-1(b)(2)(iv)(b) (2015).

80. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2) (2015).

81. Treas. Reg. § 1.704-1(b)(2)(ii)(b)(3) (2015).

82. Treas. Reg. § 1.704-1(b)(2)(ii)(d) (2015).

2. Accordance with Owner's Interest in the Firm

The regulations essentially provide that a tax allocation *is* in accordance with the owner's interest in the firm if the allocation also reflects the economic benefits or burdens, if any, behind it.⁸³ Thus, for example, an owner who bears all the expenses with respect to a particular asset may be allocated all the corresponding deductions. In general, the broad factors to be considered include the owners' relative contributions, their interests in economic profits and losses, their interests in cash flow and current distributions, and their interests in liquidating distributions.⁸⁴ Although capital accounts can feature in the inquiry, this approach does not require the same strict observance as the substantial economic effect test.

3. Deemed in Accordance with Owner's Interest in the Firm.

The core operation of this third way to justify allocations of tax benefits treats situations in which the economic risk that theoretically justified a deduction falls outside the firm rather than upon any owner. As the regulations explain: "Allocations of losses, deductions . . . attributable to [firm] nonrecourse liabilities . . . cannot have economic effect because the creditor alone bears any economic burden that corresponds to those allocations."⁸⁵ In short, an allocation will be *deemed* in accordance with an owner's interest in a firm if it provides that the recipient of the tax benefit will also receive any ultimate related tax burden. For example, assume that three of four owners are allocated all the depreciation deductions attributable to a building that was purchased for \$100 with 100% nonrecourse financing. The allocation will not be deemed to be in accordance with the owners' interest in the firm unless the three owners who were allocated the deduction are also allocated the tax burden attributable to the basis reduction caused by the allocation. There must be, in the words of the regulations, a "minimum gain chargeback."⁸⁶ Thus, if the property is depreciated down to an adjusted basis of \$20 and no principal has been paid on the mortgage, there will be a minimum gain of \$80 when the property is sold or foreclosed upon because the "relief" from the nonrecourse mortgage will be taxed, usually as "amount realized."⁸⁷ Absorbing that tax burden is the price to be paid for the depreciation

83. Treas. Reg. § 1.704-1(b)(3)(i) (2015).

84. Treas. Reg. § 1.704-1(b)(3)(ii) (2015).

85. Treas. Reg. § 1.704-2(b)(1) (2015).

86. Treas. Reg. § 1.704-2(f) (2015).

87. *Comm'r v. Tufts*, 461 U.S. 300 (1983).

deductions that reduced basis. The tax burden must go to the recipient of the tax benefit.

C. Varying Drafting Challenges and Strategies: Layer Cake and Target Allocations

The more complex a firm's economic arrangements, the more difficult it is to reduce them to writing. The difficulty is compounded by the need to include provisions to assure with some measure of confidence that any special tax allocations of tax benefits or burdens will be respected under the 704(b) rules. A significant body of literature has developed discussing various drafting strategies to allocate economic and tax consequences,⁸⁸ and a detailed discussion of these strategies is beyond the scope of this article. These strategies have their own vocabulary and can differ in significant ways, both in their approach and in their vulnerability. For example, under the "layer cake" approach, allocations of income or loss are reflected in capital accounts that ultimately will affect how cash is distributed in the event of a liquidating distribution.⁸⁹ In more recent years, "target"⁹⁰ or "forced" allocation provisions have become popular.⁹¹ These provisions do not require that liquidating distributions be made in accordance with whatever capital account balances have resulted from previous allocations. They direct how liquidating distributions will be made, and they provide for allocations of income, gain, loss, deduction, or credit that will help achieve "target" capital account balances consistent with the desired distributions in the event of hypothetical liquidation. In some cases, the allocations of each year's tax consequences are not made until after all the results for a year are clear. "In its purest form, this technique results in an agreement that contains no precise allocations."⁹² For present purposes, suffice it to say that, under either approach, capital accounts maintenance is central.

88. See generally ROBERT L. WHITMIRE ET AL., *STRUCTURING AND DRAFTING PARTNERSHIP AGREEMENTS: INCLUDING LLC AGREEMENTS* (Warren, Gorham & Lamont eds. 2014).

89. Craig Gerson, Karen T. Lohnes & John Schmalz, *Value Equals Basis and Partners' Distributive Share: Stuffing, Fill-Ups, and Waterfalls*, 105 J. TAX'N 109, 119 (2006).

90. See generally Todd D. Golub, *How to Hit Your Mark Using Target Allocations in a Real Estate Partnership*, 50 TAX MANAGEMENT MEMORANDUM 403 (Sept. 28, 2009).

91. See generally Terence F. Cuff, *Some Conjecture on Target Allocation Provisions*, REAL ESTATE TAXATION, 127 (2013); see also Terence F. Cuff, *Some Further Conjectures on Target Allocation Provisions*, REAL ESTATE TAXATION, (2013).

92. WHITMIRE, *supra* note 88, at § 5.02(2).

D. Frequent Lack of Clarity in Agreements

Attempts to assure compliance with the byzantine 704(b) regulations have resulted in operating and partnership agreements that are unclear in one of two ways. First, they can be unclear because they include complex capital account provisions, including perhaps provisions dealing with nonrecourse deductions and minimum gain chargebacks. I have seen these complex provisions even in the agreements of smaller law firms that do not involve a complex financial structure, nonrecourse financing or special tax allocations. The provisions seem to have migrated from much more complex firms on the assumption that they are tried and true. The complex provisions can also make the agreements quite lengthy. As mentioned above, proper drafting is a matter of professional judgment.⁹³ A case can certainly be made that it is good to anticipate and address in an agreement almost any financing arrangement or special allocation that might arise. However, it strikes me as overkill in many cases. It surely is unfortunate and ironic when lawyers and other owners of small businesses cannot possibly comprehend their written agreements. To the extent portions of an agreement are impenetrable and make it too lengthy, the agreement as a whole is a less effective guide or counselling document for the owners.

The second type of tax provision basically says that the owners agree to do whatever it takes to achieve tax compliance in the event of a challenge by the IRS. This approach has the advantage of allowing the agreement to be shorter and more confined to a clearer vision of the owners' economic arrangement. The disadvantage with this second approach is the risk caused by its vagueness. Perhaps that risk is reduced if it is clear that, wherever possible, the tradeoff for tax benefits will be with tax burdens rather than with hard cash. The risk is surely reduced by maximum clarity with respect to the economic arrangement.

VI. CONCLUSION

In the financial crisis that started to unfold in 2007, it became widely known that investment bankers, and their lawyers and accountants, had drafted documents for financial instruments so complex as to be beyond comprehension. However impenetrable, language and structures migrated and became widely accepted once they passed muster. Former Federal Reserve Chairman Allan Greenspan quipped that, even with more than 100 economists at his disposal, he could not

93. Brian J. O'Connor & Steven R. Schneider, *Partnership and LLC Agreements: Learning to Read and Write Again*, TAX NOTES, 1323-40 (Dec. 21, 2009).

untangle the agreements or structures behind billions of dollars of collateralized debt obligations.⁹⁴ Unfortunately, something similar, although perhaps not quite as extreme, has happened within the more modest arena of LLCs and partnerships. Despite the fact that these are two premier vehicles for small businesses with two or more owners,⁹⁵ they are often governed by agreements that are very difficult to understand. Operating and partnership agreements are often drafted by generalists who incorporate standard form language that attempts to validate special allocations of tax benefits that might be made, even if implausible. Although the relevant federal income tax regulations focus heavily on capital accounts, those capital accounts are often misunderstood and can have significant and unintended economic consequences.

My thesis is twofold. First, even apart from federal income tax law, attorneys must have at least a rudimentary understanding of what capital accounts are and are not, as well as any state default rules regulating them. The accounting profession typically *is* generating individual capital accounts for each owner, even if those accounts are not required either by the owners' agreement or by law.⁹⁶ In the world of small business, often characterized by incomplete or vague agreements and by poor record-keeping, those accounts provide at least some standardized measure of an owner's net equity in the firm. Second, capital account analysis is a useful analytical device. Walking the standard range of anticipated transactions through a capital accounts analysis can raise with great clarity and precision basic economic decisions that might otherwise be overlooked, particularly decisions regarding the sharing of different kinds of losses among the owners.

94. ANDREW ROSS SORKIN, *TOO BIG TO FAIL* 90 (Penguin Group 2009).

95. Subchapter S corporations are also quite popular.

96. There is nothing preventing owners or their agents or representatives from dispensing with capital accounts, that is, from moving to more of a corporate approach that dispenses with an equity account for each owner.

