Tax Arbitrage And Organizational Form: Allocation Flexibility in The Limited Liability Company

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Abstract

This paper analyzes whether an allocation of tax items among members of a limited liability company (LLC) will likely be respected by tax authorities. The LLC is a recent creation of state law that provides the liability protection of a corporation and the flexibility of partnership tax law. A present-value test must be satisfied to permit allocations among LLC members that are not proportionate to ownership interests to be respected. A model is developed to measure the present value of after-tax benefits and detriments arising from an LLC allocation, and implications of the availability of tax arbitrage for selection of the LLC organizational form are discussed.

1.0 Introduction

Selection of the optimal form of organization of a business activity requires consideration of a complex interaction of tax and non-tax factors. Scholes and Wolfson (1992) demonstrate that in the absence of market frictions and restrictions, exploitation of arbitrage opportunities will eliminate the dominance of any specific form of organization in the production of the same set of goods and services. However, with real world frictions, including tax law rules and tax restrictions, one form of organization may dominate for a specific production activity.

Studies have shown that the choice of organizational form is influenced by the differential taxes and transaction costs (Collins and Bey 1986; Guenther 1992; Terando and Omer 1993). Collins and Bey (1986) present an analysis, the result of which suggests that firms with high corporate tax rates and limited investment opportunities should prefer the master limited partnership (MLP) organizational form. Guenther (1992) presents evidence consistent with tax related differences between corporations and MLPs that would appear to influence the choice of organizational form. Specifically, Guenther predicts that as average tax cost increases for the corporate form relative to the partnership form that managers of corporations will react by (1) increasing long-term debt, (2) increasing non-dividend distributions, and (3) decreasing dividend payout ratios. Guenther’s empirical results support these predictions suggesting a possible relationship between the choice of organizational form and relative tax costs. Terando and Omer (1993) also investigate factors that may influence the choice of organizational form. Terando and Omer found that corporations forming MLPs prior to 1986 had higher tax costs than those corporations not forming MLPs suggesting that tax differences at least partially influenced the choice of organizational form.

As of the summer of 1993, 35 states have enacted limited liability company (LLC) legislation and an additional 10 states have legislation pending. The LLC provides members with limited liability similar to a corporation, but is structured to be treated as a partnership for tax purposes, providing “self-integration” of the tax liabilities of the entity and the owners. The LLC offers flexible management participation, capital structure options, and member qualifications that can be more attractive than an S-corporation. The explosive growth in state legislation permitting the LLC form of organization reflects the views of many business advisers that LLCs can often be more attractive than the corporate or partnership form of organization. LLCs are commonly used for venture capital, real estate, start-up enterprises, professional service firms, and family businesses.

A principal advantage of the LLC form is the ability to allocate tax items among LLC members by agreement, offering the opportunity to maximize the aggregate tax position of all members provided tax law constraints are satisfied. Similar allocation flexibility is not available to S corporation shareholders. Although partnerships have similar allocation flexibility, limited liability is not available unless participation in manage-
ment is restricted, a limitation not imposed on LLC members. As Scholes and Wolfson (1992) note, tax law restrictions limit the ability to engage in organizational form tax arbitrage, with utility maximizing behavior suggesting that the tax constraint should be pushed until it becomes binding. Tax law constrains the ability to freely allocate tax items among LLC members, and also partners, by requiring that an agreement to allocate tax items other than in proportion to ownership interests have economic effect, and also that the economic effect be judged to be substantial.

The economic effect requirement of the tax regulations can be satisfied by selection of proper language in the LLC agreement, a task best left to a skilled attorney. However, the substantiality requirement includes a required determination of the effect of the allocation on the members' tax liabilities, computed on a present-value basis. Knowledge of the present-value test is essential to use of the LLC in organizational-form tax arbitrage, and academic researchers are uniquely qualified to analyze the present-value test. In this paper, we show how an allocation can be structured to satisfy the present-value test, a necessary condition to maximizing the tax flexibility of the LLC form of organization. A model is developed to analyze the present value of tax benefits and detriments resulting from an allocation, with demonstration of how to apply the present-value test to a simple allocation scheme.

2.0 Regulatory Authority For Substantiality

If an allocation satisfies the economic effect test, which can be achieved with appropriate wording in the LLC agreement, the tax regulations provide that the economic effect is substantial only if there is a reasonable possibility that the allocation will substantially affect the dollar amounts to be received by the LLC members, independent of tax consequences. Other than this wording, the regulations provide no guidance as to when an allocation will meet the substantiality test. However, the economic effect of an allocation is not substantial if any of three tests are failed: (1) a present-value test; (2) a shifting tax consequences test; or, (3) a transitory allocation test. Although the literal wording of the Regulations does not state that an allocation will have substantial economic effect (SEE) if none of these tests is failed, commentators appear to adopt this position.

The present-value test, applicable to all allocations, states that economic effect will not be substantial if: (1) the present value of after-tax economic consequences of at least one LLC member may be enhanced by the allocation, and (2) there is a strong likelihood that the present value of after-tax economic consequences of no LLC member will be substantially diminished by the allocation. This test requires the LLC to consider at least five issues. First, the analysis requires a compari-

son of the economic effect for each member determined with and without the allocation. If the allocation were not in the LLC agreement, Internal Revenue Code (IRC) §704(b) requires that the allocation be in accordance with the members' respective interests in the LLC. There is a rebuttable presumption that all members' interests are equal, determined on a per capita basis. The members' interest in each item may differ, and the determination is a factual one which might require a fictitious sale of LLC property at book value, followed by a deemed liquidation of the LLC. The difficulty in determining the members' interests in each item creates uncertainty in the measurement of the overall-effect test. Second, the test requires a determination of economic effect using present-value concepts. Third, the effect of the allocation must consider ex-ante estimates of the members' tax situations during the term of the analysis. Fourth, it must be determined that there is a "strong likelihood" that no member will suffer diminished economic benefits. Finally, it must be determined what constitutes "substantially" diminished economic consequences.

The "shifting allocation" test refers to an allocation which does not substantially affect the net increases and decreases to the members' capital accounts, but which results in a reduction in the members' tax liabilities. This test would apply where the LLC allocation does not affect the aggregate amount of income or loss allocated to each member, but instead allocates items of a different tax character among the members. For example, an allocation of capital gain to one member and ordinary income to another within the same year would be a shifting allocation.

The transitory allocation rule applies where an allocation is expected to be offset largely with a subsequent allocation, with an expected decrease in the tax liability of the member receiving the allocation. The transitory allocation rule might apply if an income allocation to member A in one year is to be offset by a future income allocation to member B in another tax year, or a loss allocation to member A in one year is to be offset by an income allocation in a subsequent year.

In applying each of the three tests for substantiality, there is a presumption that the fair value of LLC property is equal to basis and that any adjustments to basis are matched by adjustments to fair market value. This presumption has two effects. First, allocations of deductions cannot reasonably be expected to be offset with subsequent income from the sale of the property. Second, because there cannot be a strong likelihood of an offsetting allocation, it is presumed that the allocation will substantially affect the dollar amounts to be received by the members.
The model to be used in this analysis will focus on the application of the present-value test to two common types of allocations which are not shifting allocations and which may meet the transitory allocation five-year safe harbor. The research issue then becomes, how sensitive is the present-value test to reasonable variations in relevant parameters?

3.0 Modelling the Present-Value Test

This section will develop an analytical approach to measuring the present value of benefits and detriments from an LLC allocation. A simple fact pattern will be utilized, and the after-tax economic consequences of the allocation will be analyzed for sensitivity to changes in the values of model parameters. It is expected that this analysis can be of assistance to drafters of LLC agreements since it can highlight situations where the present-value test may be expected to be violated. Tax allocations that satisfy the test can create arbitrage advantages of the LLC form over the corporate form of organization.

To construct the example, assume that the LLC has only two members. Further, the only item to allocate is a constant amount of tax deductions, with member A receiving 100 percent of the allocation. If the allocation followed the members' interests in the LLC, both member A and member B would receive 50 percent of the allocation. Therefore, the benefit to member A consists of the tax savings of an incremental allocation of 50 percent of the total deductions, and the detriment to member B is the loss of a tax benefit for 50 percent of the deductions.

If the LLC satisfies the economic effect test, there is a secondary effect of the tax allocation. At the extremes, member A will either: (1) receive a reduced amount of cash on liquidation of the LLC, equal to the sum of the incremental deductions which he has claimed; or (2) receive an increased income allocation from the LLC, equal to the sum of the incremental deductions which he has claimed. The LLC agreement will determine which effect will occur, and will typically provide for an income "chargeback" to member A. Allocations of taxable income to reverse the effect of prior loss allocations eliminate the possibility that the allocation will have an economic, rather than just a tax, effect. However, the presumption in the Regulations that allocations which decrease the basis of LLC property also decrease fair value will permit an analysis of the effects of a reduced cash distribution because it is assumed there will be no future income to satisfy the chargeback provision. The present-value test would then be applied assuming there will be no gain to allocate from the sale of LLC property.

As an illustration of a gain chargeback, assume that members A and B each contribute $100 to an LLC, which is then used to purchase $200 of depreciable property. If total depreciation deductions are $80 for a relevant time period, and all depreciation is allocated to member A through an agreement that satisfies the SEP test, member A's capital account is reduced from $100 to $20 by the allocation. Member B's capital account is unchanged at $100. Now assume that the LLC property is sold for $200, producing $80 of gain and $200 of cash to distribute to LLC members. Without a special gain chargeback, the gain is allocated equally to A and B, increasing their respective capital accounts to $60 and $140. Member A then receives $60, and member B $140 of the available $200. A gain chargeback would allocate the first $80 of gain to member A, reversing the capital account reduction created by the depreciation allocation. Both A and B then have $100 capital account balances, and share available cash equally. Note the regulatory presumption that value equals basis creates the same result with or without a gain chargeback. By assuming that the property is valued at $120, there is no gain to satisfy a chargeback, and it is presumed that member A will receive $20 and member B $100 from a deemed sale of the property and liquidation of the LLC.

An allocation of deductions intended to be offset with a subsequent allocation of income from LLC operations, rather than from the sale of LLC assets, might fail the transitory allocation test, the present-value test, or both. Expected reversals satisfied from operating income are not protected by the value-equals-basis presumption in the regulations. The transitory allocation test will not fail unless (i) the initial and offsetting allocations are expected to be similar in amount, (ii) the members' respective tax liabilities are expected to be less than if the allocations were not made, and (iii) the offsetting allocation occurs within five years. The model will allow for different tax rates to apply to the year of the initial and offsetting allocations. Irrespective of the outcome of the transitory allocation test, the present-value test will be applied assuming that the initial allocation is expected to be offset with a subsequent income allocation.

The analysis will consider the economic benefits and detriments of an incremental allocation of tax deductions to member A. First, the allocation is assumed to be depreciation deductions (intended to be offset with gain from the sale of the property), with the result that member A will be presumed to receive a reduced amount of cash on liquidation of the LLC. Second, the allocation will be assumed to be an item which will be offset with an allocation of income from LLC operations.

The present value analysis will consider the incremental benefits and detriments to member A and member
B. For consistency and ease of exposition, it is assumed that benefits and detriments occur at the end of discrete annual time periods, that the members would share equally in allocations without the special agreement, and that marginal tax rates are expected to be constant throughout the term of the allocations of deductions. All present value computations required by the IRC use discrete, rather than continuous, time. Although tax rates are assumed to not change, the tax rate applicable to offsetting gains can be the capital gain rate and may differ from the rate applicable to deductions, which would likely be the ordinary income rate. The following notation will be utilized:

\[
\begin{align*}
\text{Dep}_i & = \text{total depreciation allocations in period } i \\
\text{Dep}_{di} & = \text{total non-depreciation allocations in period } i \\
n & = \text{number of annual time periods covered by the analysis} \\
r & = \text{the risk-adjusted discount rate to be used in the analysis} \\
t_{ma} & = \text{member A's marginal tax rate for annual deductions} \\
t_{mb} & = \text{member B's marginal tax rate for annual deductions} \\
t_{ga} & = \text{member A's marginal tax rate for offsetting gains} \\
t_{gb} & = \text{member B's marginal tax rate for offsetting gains}
\end{align*}
\]

Situation 1: Allocation of Depreciation With No Gain Chargeback

The present value of the after-tax economic benefit to member A is given by the present value of an annuity equal to the tax savings of the incremental depreciation allocation:

\[
\text{Benefit} (A) = (.50) \text{Dep}_1 (t_{ma}) \frac{1 - (1+r)^{-n}}{r}
\]

(1)

The present value of the after-tax cost of receiving less cash on liquidation is:

\[
\text{Detriment} (A) = .50 \sum_{i=1}^{n} \frac{\text{Dep}_i}{(1+r)^{n}}
\]

(2)

Note that 50 percent of the total allocation is used in the analysis because it represents the incremental amount assumed to be received by member A. This assumption could be readily relaxed if the model is to be used for a different fact pattern. The after-tax economic benefit to member B is given by the present value of the incremental cash he is presumed to receive on liquidation:

\[
\text{Benefit} (B) = .50 \sum_{i=1}^{n} \frac{\text{Dep}_i}{(1+r)^{n}}
\]

(3)

The present value of the after-tax economic detriment to member B is given by the loss of the tax deductions over the term of the allocation:

\[
\text{Detriment} (B) = (.50) \text{Dep}_1 (t_{mb}) \frac{1 - (1+r)^{-n}}{r}
\]

(4)

Since the final period effect of the allocation is member A receiving less cash and member B receiving more cash (due to the presumption in the Regulations), the amount of liquidation gain allocated to each member is not affected. Thus, \(t_{gb}\) and \(t_{gb}\) do not enter into the analysis.

The Regulations require that if one member is a net winner from an allocation, then there must be a strong likelihood that one member will be a substantial loser. Since it is difficult to conceive of an allocation that is not expected to create at least one winner (one would question the rationality of the members), the analysis requires that we examine the conditions under which either A or B will be a net loser.

Member A will be a net loser if:

\[
A \text{ Loses if: } \frac{.50 \sum_{i=1}^{n} \text{Dep}_i}{(1+r)^{n}} > (.50) \text{Dep}_1 (t_{ma}) \frac{1 - (1+r)^{-n}}{r}
\]

(5)

Member B will be a net loser if:

\[
B \text{ Loses if: } (.50) \text{Dep}_1 (t_{mb}) \frac{1 - (1+r)^{-n}}{r} > \frac{.50 \sum_{i=1}^{n} \text{Dep}_i}{(1+r)^{n}}
\]

(6)

Equation (5) compares the detriment suffered by member A from receiving less cash from liquidation of the LLC with the benefit realized from incremental depreciation deductions, each measured in present day dollars. Equation (6) similarly compares the benefit realized by member B from receiving incremental liquidation cash distributions with the detriment suffered from reduced depreciation allocations, each measured in present day dollars.

Equations (5) and (6) differ only in the direction of the inequality and in the use of \(t_{ma}\) and \(t_{mb}\). If \(t_{ma} = t_{mb}\), there will clearly be one winner and one loser for any values assigned to the other variables. Since member A is receiving the allocation of deductions, it is likely that
\[ t_{ma} > t_{mb}. \] The simulation analysis will analyze the sensitivity of equations (5) and (6) to changes in parameter values.

**Situation 2: Allocation of Deductions With an Income Chargeback**

This analysis is similar to situation 1 except that the allocation of tax deductions is offset by an allocation of additional taxable income to member A. The amount of cash to be received by each member is not expected to be affected by the allocation. This type of an allocation would require consideration of the transitory allocation rule in addition to the present-value test. The transitory allocation rule is waived for an income chargeback which does not occur within five years of the original allocation. Since the five-year rule is applied on a FIFO basis, early year allocations might not be transitory, while later year allocations may be. The analysis will be based on an assumed chargeback at least for five years in the future and will then consider only the application of the present-value test.

The present value of the after-tax economic benefit to member A is given by:

\[ \text{Benefit (A)} = (.50) (\text{Ded}_1) (t_{ma}) \frac{1 - (1+r)^{-n}}{r} \]  

(7)

The present value of the after-tax economic cost of the income allocation to member A is:

\[ \text{Detriment (A)} = \frac{.50(t_{ga}) \sum_{i=1}^{n} (\text{Ded}_1)}{(1+r)^{n}} \]  

(8)

The after-tax economic benefit to member B is given by the present value of a reduced income allocation from LLC operations:

\[ \text{Benefit (B)} = (.50) (\text{Ded}_1) (t_{mb}) \frac{1 - (1+r)^{-n}}{r} \]  

(9)

The present value of the after-tax economic detriment to member B is the loss of the tax deductions over the term of the allocation:

\[ \text{Detriment (B)} = (.50) (\text{Ded}_1) (t_{mb}) \frac{1 - (1+r)^{-n}}{r} \]  

(10)

This analysis differs from situation 1 in that there is no cash flow effect, only a shifting of tax benefits and detriments. This situation requires consideration of the tax rate applicable to the period covered by the allocation of deductions as well as the tax rate applicable to offsetting income allocations.

Member A will be a net loser if:

\[ \frac{.50(t_{ga}) \sum_{i=1}^{n} (\text{Ded}_1)}{(1+r)^{n}} > (.50) (\text{Ded}_1) (t_{ma}) \frac{1 - (1+r)^{-n}}{r} \]  

(11)

Member B will be a net loser if:

\[ (.50) (\text{Ded}_1) (t_{mb}) \frac{1 - (1+r)^{-n}}{r} > \frac{.50(t_{gb}) \sum_{i=1}^{n} (\text{Ded}_1)}{(1+r)^{n}} \]  

(12)

As in situation 1, if \( t_{ma} = t_{mb} = t_{ga} = t_{gb} \), there must be one winner and one loser. Member A(B) receives more (less) current tax deductions in exchange for more(less) future income. Member B can be a winner only if he is in a relatively low tax bracket during the term of the allocations (deductions would have little value) and in a relatively high bracket at the time of the income offset (avoidance of gain would be of great value). The converse is true of member A, who cannot be a net loser unless \( t_{ma} \) is low and \( t_{ga} \) is high. This is unlikely since deductions are specially allocated to member A. Thus, member A is likely to be a net winner, with the result that member B must be a net loser. The simulation will consider the likelihood of member B losing under alternative values of model parameters.

**4.0 Results Using Simple Allocation**

Based on equations (5), (6), (11), and (12), the determination of the expected after-tax benefits and detriments can be shown to be a function of six variables:

\[ \text{Overall-Effect} = f (r, n, t_{ma}, t_{mb}, t_{ga}, t_{gb}) \]

To illustrate use of the model, we use tax rates for ordinary deductions (\( t_{ma} \) and \( t_{mb} \)) of 15 percent and 39.6 percent, the lowest and highest rates following the 1993 Revenue Reconciliation Act. The assumed rate for capital gain chargebacks (\( t_{ga} \) and \( t_{gb} \)) is either 15 percent or 28 percent, the lowest and highest rates for net capital gain income.

Table 1 shows that, without an income chargeback, there will always be a net loser from the allocation, and the loss will likely be judged substantial in relation to the amount of the allocation. The present-value test will then be likely to fail, although the IRS might nonetheless argue that the detriment to member A is not substantial in relation to all allocations made by the LLC. The risk of such an argument is not expected to be significant.

Our analysis demonstrates several scenarios where the present-value test might fail when an allocation of deductions is offset with income. Table 2 shows the net
benefit or detriment at discount rates of 6%, 8%, and 10%, under various tax alternatives. Since member A is trading a current deduction for future income, he is the economic winner from the allocation under any of the scenarios presented.

As shown in Table 2, member B is a net loser from the allocation under most tax rate assumptions. If B is in a low (15 percent) tax bracket during the term of the allocations, the loss of a current tax deduction is not a significant detriment to him. If B is in a high (28 percent or higher) tax bracket at the time of the income chargeback, avoidance of an income allocation is a significant benefit to him. For these reasons, B is a net winner from the allocation where $t_{ab} = 15\%$ and $t_{gb} = 28\%$. In this situation, the overall-effect test is clearly not satisfied and the allocation lacks SEE.

An additional problem may arise where $t_{ab} = 15\%$ and $t_{gb} = 15\%$. In this case, B experiences a detriment from the loss of the tax deductions, however, the loss may not be substantial, as required by the regulations. Table 2 shows the detriment to B to be as small as 3.5 percent of every dollar of allocation. Thus, the present-value test may fail when member B is in a low tax bracket throughout the term of the allocation.

and special tax allocations were typically associated with investment syndications in real estate, oil and gas, and equipment leasing. Syndicate investors were often homogeneous with respect to tax position, and generally were in high tax brackets. By contrast, LLCs may be expected to be used in a variety of business operations, to take advantage of the combination of liability protection and tax flexibility. LLC members may then be expected to be more heterogeneous with respect to tax position, creating a demand for tax arbitrage in allocation schemes. Also, it may be more likely that the effect of an allocation of deductions will be offset with operating income rather than only from the sale of entity properties. Our analysis reveals that tax heterogeneity and operating income chargebacks require greater caution to profit from organizational form tax arbitrage.

5.0 Conclusion and Recommendations

The LLC form of organization offers non-tax advantages of a corporation with the ability to allocate tax items by agreement. However, a present-value test must be satisfied for tax allocations to be respected by the tax authorities. Results of the simulation presented in this paper suggest that the present-value test will not be a concern for any allocation which will not be offset with an income chargeback. The presumption that reductions

<table>
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<th>Discount Rate</th>
<th>$t_{ab}$</th>
<th>$t_{ga}$</th>
<th>$t_{gb}$</th>
<th>$t_{gb}$</th>
<th>5-Year Ben/(Det) A</th>
<th>5-Year Ben/(Det) B</th>
<th>10-Year Ben/(Det) A</th>
<th>10-Year Ben/(Det) B</th>
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<td>.396</td>
<td>N/A</td>
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<td>.396</td>
<td>N/A</td>
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<td>.396</td>
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<tr>
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<td>.15</td>
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<tr>
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NOTE: The table values reflect the net present value, in dollar terms, of economic benefits or detriments over the term of the allocation. A one dollar annual allocation will generate a net benefit or detriment as shown above.

Prior to the enactment of LLC statutes, only partnerships were subject to the section 704(b) allocation rules, in tax basis are matched with reductions in fair market value will protect any allocation which will be offset with gain from the sale of LLC property. Although the
Table 2
Member’s Net Benefit (Detriment) With Income Chargeback

<table>
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<tr>
<th>Discount Rate</th>
<th>$t_{na}$</th>
<th>$t_{ga}$</th>
<th>$t_{nb}$</th>
<th>$t_{gb}$</th>
<th>5-Year Ben/(Det)</th>
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<td>.28</td>
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<tr>
<td>8%</td>
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<td>.15</td>
<td>.28</td>
<td>0.5353</td>
<td>(0.3141)</td>
</tr>
<tr>
<td>10%</td>
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<td>0.5177</td>
<td>(0.5177)</td>
</tr>
</tbody>
</table>

NOTE: The table values reflect the net present value, in dollar terms, of economic benefits or detriments over the term of the allocation. A one dollar annual allocation will generate a net benefit or detriment as shown above.

The present-value test is not waived under this presumption, a "safe harbor" appears to exist for any reasonable allocation.

Where the LLC expects to offset a loss allocation with an allocation of income from LLC operations, the present-value should be tested using prospective financial information. If the member(s) not receiving the loss allocation is(are) expected to have a fixed tax rate over the life of the LLC, the present-value test should be conducted using a discount rate based on the risk of the LLC operations.\(^\text{18}\) The higher is the selected discount rate, the more likely it is that a substantial loser will exist (see Table 2). If the partner(s) not receiving the allocation is(are) expected to be in a higher tax bracket during the term of the allocation than at the time of the income offset, a lower discount rate is more likely to lead to a substantial loser. The use of the (risk-free) applicable Federal rate specified in IRC §1274 of the tax code might be appropriate in such a situation. If the member(s) not receiving the allocation is (are) expected to be in a low tax bracket during the term of the allocation and a high tax bracket of the time of the income offset, the allocation might not produce a loser. This
scenario would require that particular attention be directed to the present-value test.

It is essential to note that the income offset analysis is limited to consideration of the present-value test. Such an allocation might fail the transitory allocation test, either in whole or in part. However, it is more likely that the present value overall-effect test would present the drafter of a LLC agreement with interpretation problems. The results of this simulation may be useful in identifying potential problem areas.

6.0 Suggestions for Future Research

As LLCs become more prevalent, with the LLC form selected for a variety of business operations, it is expected that the types of allocations and tax situations of the members will complicate application of the SEE test. Future research could expand upon the model presented in this paper to permit tax planners to maximize the advantages of the LLC form to specific business operations and ownership structures. Also, the tax law is increasingly embracing the use of present-value concepts, particularly by regulation, and business researchers should find many opportunities to assist business owners in applying present-value principles to tax problems.

###Footnotes###

1. As of the summer of 1993, the IRS has ruled that state LLC statutes in CO, DE, FL, KS, NV, TX, UT, VA, WV, AND WY will result in partnership status under the tax laws. Rulings with respect to other states are expected to be issued in the near future.

2. For example, an S corporation cannot have a foreign investor, which is permitted in the LLC form.

3. Not all state LLC statutes permit professional service organizations to operate in LLC form.


5. Treas. Reg. §1.704-1(b)(2)(iii) clearly states that the three tests only define when an allocation will NOT have SEE, and does not support the use of the tests as a safe harbor. Also, the examples provided in Reg. §704-1(b)(5) generally conclude only that the economic effect of an allocation will not be insubstantial under a particular test. There are a limited number of examples which conclude that SEE exists (see examples 3, 10(i), and 12(ii) as illustrations), with others concluding that some part of the allocations has SEE (see 7(i) and 12(i)), or that an allocation might have SEE (example 7(iii)).


8. Treas. Reg. §1.704-1(b)(3)(ii) and (iii).

9. Limberg and Jones (1988) developed a model which could be used to measure the substantiality of an allocation. The principal focus of their analysis was the determination of substantially diminished economic consequences. They considered three alternatives for measurement of "substantially" - an absolute dollar amount, and two ratio tests.


12. This is true even if the LLC expects the property to appreciate in value. See example 1(xi) of Treas. Reg. §1.704-1(b)(5).

13. An analytical present-value model could be constructed for an increase or decrease in expected tax allocations, or for an allocation other than the extreme case shown here. The constant value deduction and 100 percent allocation is shown for ease of exposition.

14. Treas. Reg. §1.704-1(b)(2)(ii) requires capital account maintenance in accordance with the Regulations and for liquidating distributions to follow the capital accounts. This produces the secondary effect, in which a dollar of deductions reduces the member's capital account, and right to LLC assets, by one dollar.

15. This is the assumption used in the Limberg and Jones (1988) study.

16. These are clearly not the only alternatives. However, they illustrate the boundaries of the economic effect of the allocation. The best case scenario, from the standpoint of member A, is an allocation of additional income (which would require consideration of the transitory allocation rule). The worst case scenario is a reduced amount of money upon liquidation.

17. It is also necessary to state that the LLC expects that there will be sufficient income to allocate. If the LLC activities are sufficiently speculative, this may not be the case. See examples 3 and 19(ii) of Treas. Reg. §1.704-1(b)(5). Of course, speculative operations justify a higher discount rate.

18. The Regulations offer no guidance in selecting a discount rate. Since the members possess asymmetric information with respect to the risk characteristics of LLC operations, they should be able to justify a risk-adjusted discount rate. However, the accepted use of the IRC §1274 applicable Federal rate should provide a safety-net floor for the discount rate.

###References###


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