

**JOHN CUNNINGHAM'S LLC NEWSLETTER  
FOR TAX AND LEGAL PROFESSIONALS**

ISSUE NO. 45 (JULY 13, 2007)

**DEMYSTIFYING LLC PARTNERSHIP TAXATION—THE  
CONCEPT OF THE “STRAIGHT-UP PARTNERSHIP”**

---

---

EXECUTIVE SUMMARY

The key to understanding how to draft and review federal tax provisions in LLC agreements of LLCs taxable as partnerships is to understand the concept of the “straight-up partnership.” Partnership tax can be very complicated, but straight-up partnerships are simple.

DISCUSSION

As discussed in last month's newsletter, about half of all LLCs are multi-member LLCs, and, for better or worse, most multi-member LLCs are subject to the default federal tax regimen of partnership taxation under Internal Revenue Code Subchapter K. (As readers will know, I believe that many multi-member LLCs should instead be taxable as S corporations.)

As all accountants are aware, partnership taxation can be very complex; but the basic federal tax framework of LLCs taxable as partnerships is simple—it is the framework of a “straight-up partnership.” In this framework, the members' respective shares of contributions to the LLC determine their allocations of LLC profits and their distributions of LLC cash and other assets; and the tax structure of the LLC is identical to its economic structure. I contribute one third of the LLC's cash; and I get a third of its allocations and distributions. Period.

My rough guess is that at least 90% of all LLCs taxable as partnerships are straight-up partnerships and that, accordingly, they need only the contribution, allocation and distribution provisions that I've just described. And part of the beauty of these provisions is that you don't have to be a CPA or to have a master's degree in taxation to understand them. On the contrary, they can be understood by any business person with a college (or, for that matter, a high school) education.

The above brief description of the tax provisions in the LLC agreement of an LLC taxable as a straight-up partnership requires only two important qualifications:

- The “Prop. Reg.” If most of the members of a particular multi-member LLC are passive investors but one of them is also an LLC manager and wants to avoid Social Security Taxes (called the “Self-Employment Tax” (the “SET”) in the case of partnerships), the LLC agreement of the LLC should contain not only the straight-up partnership provisions described above but also a small number of

specialized provisions required for compliance with IRS LLC SET-avoidance rules. These rules are set forth in an IRS proposed regulation designated Prop. Reg. § 1.1402(a)-2 (the “Prop. Reg.”). In essence, the Prop. Reg. requires that the LLC agreement provide for two separate classes of interests—an investor class, in which all of the members will participate; and a manager class, in which only the managers will participate. This simple structure can save LLC member-managers thousands of dollars a year in SET liabilities.

- Special allocations. In addition, if any of the members successfully negotiates for “special allocations” of particular types of tax deductions or other tax items, the LLC agreement, although its principal tax provisions will be straight-up partnership provisions, must also contain specialized provisions that mirror “safe harbor” IRS regulations governing special allocations. (Special allocations are allocations that differ from the basic interest of the partners. For example, a member of an LLC taxable as a partnership who, in general, is entitled to one third of the LLC’s profits might negotiate to obtain a special allocation of *all* of the LLC’s tax credits.)

Thus, if a member is entitled to special allocations relating to deductions in respect of LLC real property purchased with the proceeds of a non-recourse loan (i.e., a loan secured only by the property itself and not by other assets of the LLC or the members), the basic tax provisions of the LLC agreement will still be straight-up partnership provisions, but the agreement will also contain “plug-in” provisions concerning partnership non-recourse debt, partnership minimum gain, partner minimum gain and partnership and partner minimum gain charge-backs.

However, in many LLC agreements for multi-member LLCs, the above Prop. Reg. provisions won’t be needed; in most such agreements, the above special allocations won’t be needed; and the straight-up partnership provisions in all of these agreements are a matter of simple economics and, indeed, simple arithmetic.