A commonplace practice of drafting LLC agreements is the use of “units” as substitute for a bundle of economic, voting and tax rights. Using units in this way seemingly simplifies the complexity of actual LLC membership interests, as though they were corporate stock. Units are easier to draft and explain to clients. But the simplification is more imagined than real, and is very dangerous. Units have no recognition in state organizational law or tax law, and their use in LLC agreements risks misallocation economic and voting rights and tax benefits and liability, depriving members of an LLC of the benefits of their underlying bargain. This program will provide you with a practical guide to the pitfalls of using “units” when drafting LLC agreements and how to avoid – or correct – them.

- Dangers of using “units” in drafting LLC agreements
- How units in LLCs do not accurately substitute for the complex bundle of management and voting, economic and tax rights in LLCs
- Management rights – how units generally overstate voting and governance rights
- Economic rights – how units may deprive LLC interest holders of their full financial rights
- Tax issues – how units can substantially confuse tax issues and cause significant adverse outcomes
- Identifying unit-based problems in existing LLC agreements – and how to correct them

Speakers:

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Dangers of Planning With LLC "Units"

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Today’s Topics

1. Overview.
   ■ LLCs are *unincorporated* entities
   ■ Paradigms for drafting LLC operating agreements:
     ■ LLCs as alliances or joint ventures (without "units").
     ■ LLCs as corporation substitutes (with "units").

2. What do you get when you acquire a "unit"?
   ■ Governance rights? How "units" can overpromise the transfer and exercise of voting rights.
   ■ Economic rights? How "units" may shortchange interest holders of the benefit of their bargain.

3. Tax issues.
   ■ How the sale of "units" among members can lead to unpleasant tax surprises.
   ■ How the issuance of "units" can lead to unpleasant tax surprises.
Overview

- LLCs are *unincorporated* entities
- Paradigms for drafting LLC operating agreements:
  - LLCs as joint ventures (without "units").
  - LLCs as corporation substitutes (with "units").
Unincorporated Entities

- There is no such thing as a Limited Liability Corporation.
- "LLC" = Limited Liability Company.
- Because LLCs are so flexible, they can be made to resemble corporations.
  - The resemblance is often superficial and misleading.
  - Both for tax purposes and business law purposes, LLCs often behave very differently than corporations.
- We focus here on LLCs, but much the same thing can be said of other unincorporated business entities, including limited partnerships and general partnerships.
Unincorporated Entities

- The LLC "unit" may look like a share of corporate stock. Looks can be deceiving.
- State corporation laws provide for shares of stock.
- State LLC laws do not provide for LLC units.
  - The term LLC "units" has no fixed meaning.
  - It is whatever the parties want it to be.
  - It is not required.
  - Without examining the LLC’s operating agreement, you have no idea what – if anything – the term "unit" means for that LLC.
Unincorporated Entities
Often Taxed as Partnerships

- For federal income tax purposes (and most state tax purposes), "LLC" usually equals "partnership."
- Most LLCs and other unincorporated entities – but not all – are classified as partnerships for income tax purposes. See Treas. Reg. § 301.7701-2, -3.
- With minor exceptions, tax law simply ignores the division of LLC/partnership interests into "units."
Two Drafting Paradigms

1. Joint Venture Style:
   - LLC resembles a contract or strategic alliance.
   - Rights and relationships among the owners.
   - Less emphasis on the LLC as an entity separate from the owners.
   - Nothing is "issued" to the members.

2. Corporation Style:
   - LLC resembles a corporation.
   - Focus on the LLC as a separate entity.
   - Rights and relationships among the owners are framed as interests in an entity.
   - "Units" are "issued" to the Unitholders.
LLC as Joint Venture: Example of Governance Issues

- Andrea, Bob, and Carol are the initial members of LLC.
  - Distributions are always 1/3 each.
  - Andrea is the sole manager.
  - Some decisions require the consent of two members.
  - The most important decisions (such as amending the operating agreement) require consent of all three members.
  - The interests are intended to be nontransferable; if a transfer has to be recognized the transferee gets no governance rights.
LLC as Corporation Wannabe: Example of Governance Issues

- Andrea, Bob, and Carol are the initial "Unitholders" of an LLC.
  - Each Unitholder is "issued" 100 Class A Common Units, with equal voting rights.
  - There is a three person "Board of Directors."
  - All Directors must be Unitholders.
  - Voting for Directors is by Unit.
  - Tight transfer restrictions are placed on the Units.
  - "Officers" are required and Andrea is voted the initial President, Treasurer, and Secretary.
  - Decisions are generally made by a majority of the Board.
  - The most important decisions are recommended by the Board and require unanimous consent.
Why Use the Corporate Language?

- **Member vs. Unitholder**
  - "Members" are provided for in state LLC acts.
  - "Unitholders" are not provided for in any state LLC acts.
  - Is a "Unitholder" automatically considered a member?
  - Are Andrea, Bob and Carol members?
  - Can a Unit be held by a nonmember?
  - If a Unit does get transferred, do voting rights automatically go along with it?
  - Under LLC law in general, transfer of an interest does not automatically convey voting rights to the transferee; by default, even if the transfer is permitted, the transferee is not automatically admitted as a member.
  - If the intent is for Andrea, Bob, and Carol as individuals to have equal voting rights, why link voting rights to ownership of "Units"?
Why Use the Corporate Language?

Manager vs. Officer/Director
- "Manager" is provided for in state LLC acts.
- "Officer" and "Director" are generally not provided for in state LLC acts; the terms are simply not used.
- What do "Officer" and "Director" mean?
  - Are the holders of these positions managers?
  - Do they have fiduciary duties?
  - If a Unitholder votes on a matter, is the Unitholder voting as a member or as a director, and what is the difference?
  - Is there a need for "Officers" when the intent is for Andrea to be the sole manager?
  - Is there any reason to have "Directors" when the intent is to require certain decisions to be made by majority vote of the members?

Has the corporate language made the operating agreement clearer or hazier?
LLC as Joint Venture: Example of Economic Issues

- Dave contributes $70.
- Ellen contributes $30 and services.
- Each member has equal voting rights.
- Distributions are made 70/30 until the LLC returns the $100 of capital, plus a 5% return.
- After that point, distributions are 50/50.
LLC as Joint Venture

- The operating agreement does not refer to the issuance of units, or to the issuance or authorization of anything at all.
- Like most contracts the operating agreement:
  - Describes the rights and obligations of the parties.
  - Does not purport to "issue" anything to the parties.
- The operating agreement generally makes rights nonassignable.
LLC as Corporation Substitute

- Alternatively, the operating agreement may translate the deal into "units."

- **Preferred Units.** Two series of Convertible Preferred Units:
  - Member X purchases 70 Series A Convertible Preferred Units at $1 per unit. Each Series A Convertible Preferred Unit has 5/7 vote prior to conversion.
  - Member Y purchases 30 Series B Convertible Preferred Units at $1 per unit, with each unit carrying 1 2/3 vote.

- **Common Units.** A total of 140 Common Units are authorized.
  - After the LLC returns the $100 of capital plus 5%, Preferred Units are convertible into Class A Common Units on a 1:1 ratio.

- **Warrant.** Y has a warrant to acquire another 40 Class A Common Units at a penny per unit.
  - The warrant becomes exercisable under the same conditions that the right to convert the Preferred Units becomes exercisable.
LLC as Corporation Substitute

- The units and warrant are not transferable.
- The translation draws attention away from X and Y individually, and focuses on the entity.
  - JV-style LLC:
    - X and Y have certain rights.
  - Corporate-style LLC:
    - The LLC issues three classes of units, plus a warrant. The units and warrant are issued to X and Y.
- Did X and Y have any reason for rephrasing their arrangement in terms of units and warrants?
What Did the Translation Accomplish?

- It is unclear whether the translation accomplished anything.
- Corporate-style language adds greatly to complexity.
- Some parties or their lawyers feel more comfortable with entities that look like corporations.
- Consider whether that sense of comfort is justified.
What Do You Get When You Acquire a "Unit"?

Economic rights?
How "units" may shortchange LLC interest holders of the benefit of their bargain.

Governance rights?
How "units" can overpromise the transfer and exercise of voting rights.
What is Transferred?

- A corporation is clearly a separate entity.
  - Sale of a corporation is either:
    - sale of stock (interests in the entity), or
    - sale of assets.

- Is an LLC or a partnership a separate entity?
  - In many ways it is separate.
  - In some ways it is an aggregate of the members.
  - Interests in an unincorporated entity are often harder to identify than corporate stock.
What is Transferred?

- LLC Interests?
- Partnership Interests?
- Profits Interests?
- Percentage Interests?
- Membership Interests?
- Governance Rights?
- Units?
- Shares?
- Economic Interests?
What is Transferred?

- All these expressions are commonly used in practice.
- There is no all-encompassing uniform term for what is transferred -- nothing exactly like "shares" of a corporation as defined in state statutes.
- Nothing keeps an LLC from calling interests "shares" or "units" (or even "stock") but these terms are not found in state limited liability company acts.
What is Transferred?

- The crucial point is not the terminology but the nature of the rights and obligations.
- You must examine the Articles of Organization or Certificate of Formation and the Operating Agreement.
Unbundling the Rights

- Terms like "shares" or "units" are especially misleading if you think that the IRS will pay any attention to them.
- You cannot separately identify which "shares" or "units" are being sold in determining holding period (except for certain publicly traded partnerships) or in determining basis.
Economic and Noneconomic Rights

- Two broad categories of rights:
  - *Economic Rights*, for example:
    - Current Distributions.
    - Liquidating/Capital Distributions.
    - "Guaranteed payments"?
    - Rights in other capacities (e.g., repayment of loan to LLC)?
  - *Noneconomic Rights*, for example:
    - Vote on LLC decisions.
    - Participate in management.
    - Receive information.
Economic Rights

- Economic rights can be subdivided into two other broad categories:
  - Capital Interest.
  - Profits Interest.
- Capital interests and profits interests are both, in essence, rights to distributions.
Economic Rights

- "Capital Interest" =

  Any interest that would give the holder a share of the proceeds if the LLC's assets were sold at fair market value and the proceeds distributed in a complete liquidation of the LLC. See Rev. Proc. 93-27, 1993-2 C.B. 343.

- "Profits Interest" =

  Any LLC interest other than a capital interest.
Economic Rights

- "Capital Interest"
  - A $1,000 Capital Interest does not necessarily have a true value of $1,000 to the purchaser.
  - Practically speaking, there are almost always limits on causing a liquidation and receiving the $1,000.
  - Capital Interests often are expressed as a dollar amount, not a percentage.
  - However, if someone has a $1,000 capital interest in an LLC, and the LLC has $10,000 total capital interests, you can say that she has 10% of the capital interests.
Economic Rights

- "Profits Interest."
  - A profits interest can be something as simple as a percentage of income.
  - At the other extreme, it can take the form of a multi-level "waterfall."
Economic Rights

- **Example of Waterfall:**
  - *First*, 100% of profits allocated to Member A, until Member A is allocated an amount equal to 11% interest on her unreturned capital contributions.
  - *Second*, 80% to Member A and 20% to Member B until Member A has been allocated $1,000,000.
  - *Third*, 100% to Member C until Member C has been allocated $100,000.
  - *Fourth*, 60% to Member A, 20% to Member B and 20% to Member C until Member A has been allocated another $1,000,000.
  - *Fifth*, 20% to Member A, 40% to Member B and 40% to Member C.
Economic Rights: Simple Example

- A and B form an LLC.
- Each one contributes $100,000; each one gets 40 units.
- They want C to work for the LLC. They admit her as a member and give her 20 units.
- C therefore has 20 out of 100 units.
- Does C have a 20% "interest" in the LLC?
Economic Rights: Simple Example

- **Yes and no.**
- The parties may have intended for C to get a 20% interest in profits.
- It is unlikely, however, that the parties intended for C to get a 20% interest in capital.
- A and B (if they are like most investors) expect that, if the LLC liquidates the day after C joins, A and B get their capital back and C gets nothing.
What About Noneconomic Rights?

- Governance Rights.
  - Right to vote.
  - Right to participate in management of the LLC’s business.

- Other Rights.
  - Right to receive, or have access to, information.
  - Right to seek judicial dissolution.
Noneconomic Rights

- Most state LLC statutes separate noneconomic and economic rights.
- A limited liability company interest is only "a member’s share of the profits and losses of a limited liability company and a member’s right to receive distributions of the limited liability company’s assets." Del. Code Ann. 6 § 18-101(8).
Noneconomic Rights

Governance rights can be inadvertently lost when transferring units.

- An assignee (whether of units or membership interests) will generally receive only economic rights until separately admitted as a member.

- "An assignment of a limited liability company interest does not entitle the assignee to become or to exercise any rights or powers of a member; . . ." Del. Code Ann. 6 § 18-701(b)(1)
Noneconomic Rights

- "Membership" usually implies some noneconomic rights.
- The difference between an "economic interest holder" and a "member" usually is that the member has some noneconomic rights that the economic interest holder lacks.
- However, don’t assume that certain rights automatically come with being a "member."
- The Operating Agreement can define "membership" rights down to almost nothing.
- Do "units" figure into these issues.
What About Noneconomic Rights?

- C is a member and holds 20% of the units.
- Does C have any noneconomic rights?
  - Answer: Look at the Operating Agreement.
- There is nothing about being a member or holding units that necessarily conveys significant noneconomic rights.
Noneconomic Rights

- For example, in a joint venture LLC:
  - Voting rights may be limited to "Major Decisions."
  - No right to participate in management for non-managing members.
  - Limited rights to access information.

- In a corporation style LLC:
  - Unless clearly stated in the operating agreement, rights of unitholders may be limited to the default rights under the applicable state LLC Act.
Tax Issues

- How "units" can lead to unpleasant tax surprises:
  - On a sale of units among members.
  - On the issuance of units.
Sale of Units

- On December 31, 2009, X buys 5 LLC Units from Y for $1,000.
- On December 31, 2010, X buys 5 LLC Units from Z for $10,000.
- On January 1, 2012, she sells the Units acquired from Z, and receives $10,000.
- Assume all Units have equal rights (which in reality may not be the case).
"Simple" Tax Question?

- "Quick question"
- The seller doesn’t have any income, does she?
- She bought five units for $10,000 and sold them for $10,000.
- She just broke even, right?
  - No.
  - On these facts, there is no reason to think that seller broke even.
Tax Questions

1. Does she have taxable income?
2. If so, does she have capital gain or ordinary income?
3. If capital gain, is it long-term or short-term?
4. If it is long-term, is it eligible for the 15% maximum individual capital gain rate?
"Simple" Tax Questions?

- The answer to all these questions is: *it depends.*
- We need more facts to answer any of these questions.
Did she break even?

*Answer: We need more facts.*

X’s basis in the units will be affected by:
- Allocations of income/loss.
- Distributions.
- Contributions.
- Borrowing by the LLC.

For simplicity, make the unrealistic assumption that none of these adjustments had to be made.

So if no adjustments were made, did she break even?
Taxable Income?

- If her basis was simply the amount she paid for her units, she did not break even.
- She has taxable income.
- For tax purposes, ignore the division of her interest into "Units."
- She sold an interest in an LLC; she did not sell "units."
- We treat her simply as selling one half her interest.
Taxable Income?

- If her basis was what she paid, she has $4,500 in income:
  - Her total basis was $11,000, and she sold half her interest.
  - Half of $11,000 is $5,500.
  - Thus she received $10,000 for property with a basis of $5,500.
  - $10,000 minus $5,500 equals $4,500 of income.

- "Units" or other terms for dividing up X’s interest are essentially irrelevant.
Capital Gain?

- Does she have capital gain or ordinary income?
- **Answer:** We need more facts.
- General rule: Gain on sale of LLC interest is capital (Code § 741).
- Exception:
  - Income is ordinary to the extent attributable to so-called "hot assets" (Code § 751).
  - Hot assets include “depreciation recapture and, more generally, unrealized receivables and inventory.
  - A "unit" in itself is not any kind of asset; what matters are the underlying assets of the LLC
- Assume for simplicity that the LLC has no "hot assets."
Holding Period?

- To the extent she has capital gain, is it long-term capital gain?
- **Answer:** We need more facts.
- She held her Units for longer than a year and a day, but her holding period is not necessarily long-term.
- Except in the case of certain publicly traded LLCs, a "unit" does not have a holding period.
- She has a holding period in her LLC interest, which can be affected by capital contributions she made to the LLC.
- We need to know if she made any capital contributions.
Holding Period?

- Suppose the LLC made a $1,000 per Unit capital call, and X paid $10,000 to the LLC on December 31, 2011.
- When X sells 5 Units on January 1, 2012, she gets $15,000 instead of $10,000.
Holding Period?

- Economically, she is in more or less the same place -- almost exactly as if she had sold the 5 units for $10,000 but had not made a capital contribution the day before.

- She simply paid $5,000 towards the 5 Units, and got back $5,000 the next day on selling the Units.

- However, her tax treatment is changed.
Holding Period?

- She has the same total amount of gain.
- Economically all the gain is long-term.
- However, the tax regulations say $\frac{1}{3}$ of her gain is short-term, and taxable at ordinary rates.
Holding Period?


11,000 + 10,000 = 21,000
  = total basis.
21,000/2 = 10,500
  = half of basis.
15,000 - 10,500 = 4,500
  = total gain on sale of half of interest.
20,000 + 10,000 = 30,000
  = value of total interests after 12/31/11 contribution.
10,000/30,000 = 1/3
  = portion of holding period beginning 12/31/11
4,500/3 = 1,500
  = amount of short-term capital gain
Holding Period?

If you are aware of this bizarre rule, which bifurcates the holding period, you may be able to plan around it.

– Example: X might have made a convertible loan instead of a capital contribution, or simply delayed the capital contribution.
Capital Gains Rate?

- Suppose we have decided that X has $4,500 of long-term capital gains.
- Can’t we at least tell what capital gains rate applies?
- **Answer: No.** We need more facts.
- LLC interests are *not* automatically eligible for the 15% rate, which is generally the maximum long-term individual capital gain rate.
Capital Gains Rate?

- Many real estate partnerships have large amounts of 25% long-term capital gain ("unrecaptured section 1250 gain," defined in Code § 1(h)(6)).
- Some partnerships have long-term capital gain on "collectibles" (art, antiques, stamps, etc.), subject to a 28% rate.
- X’s tax rate depends on whether her gain is attributable to unrecaptured section 1250 gain or collectibles.
Aggregate Versus Entity Taxation

- Tax consequences to purchaser and seller illustrate that there is a tension between the aggregate conception and the entity conception:
  - **Aggregate**: Members are co-owners, each with an interest in the LLC’s assets.
  - **Entity**: LLC is separate entity, much like a corporation; Members own an interest in the separate entity.
Aggregate Versus Entity Taxation

- The aggregate conception would treat the sale as the sale of an interest in each and every underlying asset of the LLC:
  - Seller would get capital gains or ordinary income, depending on the assets of the LLC.
  - The basis of the LLC’s assets would be increase.
Aggregate Versus Entity Taxation

- The entity conception would treat the sale more like the sale of corporate stock:
  - Seller would get capital gains treatment, without regard to the character of the assets of the LLC.
  - The basis of the LLC’s assets would be unaffected.

- Partnership tax is a confusing mixture of entity and aggregate concepts.
Issuance of "Units"

- The following example shows two alternatives for drafting allocation/distribution provisions of an LLC operating agreement.
- In the first:
  - The "Units" are received by the workers as tax-free profits interests, *but*
  - Surprisingly, "Units" of the same class turn out to have different economic rights.
- In the second:
  - "Units" of the same class have the same economic rights, *but*
  - Surprisingly, the "Units" are taxable as capital interests to one group of workers.
Allocations and Distributions

- An LLC distribution is an amount that the LLC member receives.
- An LLC allocation is an amount of profits, losses, or other items that are attributed to the member on the LLC's books.
- Normally -- although there are some very important exceptions -- the distribution is tax-free and the allocation is taxable.
- The allocation is taxable whether or not there is a corresponding distribution.
Traditional Allocations

- Traditional (layer-cake) allocation.
  - *Specifies the allocation* of income and loss.
  - Liquidating distributions are made so as to match allocations.
    - More precisely, the distributions are made in accordance with the capital accounts, which in turn reflect the allocations that have been made.
  - Considered the safer approach under the tax regulations.
  - May give the members less certainty about the way liquidating distributions will be made.
Targeted Allocations

- Targeted (forced) allocation.
  - *Specifies the distribution* of proceeds on liquidation of the LLC.
  - Allocations are made so as to match liquidating distributions.
    - More precisely, allocations are made so that capital accounts (subject to some adjustment) equal the amounts that would be distributed on a liquidation of the LLC at book value.
  - Increasingly popular drafting method, despite less certainty under the tax regulations.
  - May give the members more certainty about the way liquidating distributions will be made.
Example: Traditional Allocations

- Investors put in $1,000 and get 50 Class A Units.
- Workers put in services and get 100 Class B Units.
  - 50 Class B Units are issued on the first day of Year One, when the net value of all the LLC's assets is $1,000.
  - 50 Class B Units are issued on the first day of Year Two, when the net value of all the LLC's assets has increased to $3,000.
  - Nothing else of relevance occurs during the year (i.e., no capital contributions, distributions, profits, or losses).
Example: Traditional Allocations

- Allocation of Profit and Loss:
  - Allocate profits to offset prior losses.
  - Allocate all remaining profits pro rata by unit.
  - Allocate losses in accordance with capital accounts.

- Before the Year Two Class B Units are issued, the $2,000 of increased value is treated as profit for purposes of "booking up" (restating) capital accounts of all unit holders.
  - Capital accounts for Class A Units and Year One Class B Units are increased by $2,000/100 = $20 per unit.
Example: Traditional Allocations

- Liquidating Distributions:
  - Distribute proceeds in accordance with capital accounts.
- Does this work?
  - Greatly oversimplified, but generally yes.
- On immediate liquidation after the Year Two units are received:
  - Class A Units first get back $1,000.
  - $2,000 is distributed pro rata between Class A Units and Year One Class B Units ($20 per unit).
  - Holders of Year Two Class B Units get nothing.
  - Even if all Class B Units looked the same on the surface, they in fact carried different rights; they were associated with different capital accounts.
  - All Class B Units are profits interests
    - However, some Class B Units carry greater distribution rights than others.
Example: Targeted Allocations

- Same basic facts.
- Investors put in $1,000 and get 50 Class A Units.
- Workers put in services and get 100 Class B Units.
  - 50 Class B Units are issued on the first day of Year One, when the net value of all the LLC's assets is $1,000.
  - 50 Class B Units are issued on the first day of Year Two, when the net value of all the LLC's assets has increased to $3,000.
  - Nothing else of relevance occurs during the year (i.e., no capital contributions, distributions, profits, or losses).
Example: Targeted Allocations

- Liquidating Distributions:
  - Distribute proceeds in accordance with Units (with the first $1,000 going to the Class A Units).

- Allocation of Profit and Loss:
  - Allocate as needed so that capital accounts are equal to the required liquidating distributions.

- $2,000 of increased value is treated as Profit for purposes of "booking up" (restating) capital accounts of all unit holders, so that capital accounts equal amounts that would be distributed on liquidation.
  - Capital accounts for Class A Units and Class B Units are increased by $2,000/150 = $13.33 per unit.

- On liquidation, Class A Units get back their capital, and then all distributions are pro rata by unit.

- Does this work?
  - No.
Example: Targeted Allocations

- On liquidation, Class A Units get back any unrecovered capital, and then all distributions are pro rata by unit.
  - Class A Units first get $1,000.
  - Additional $2,000 is shared pro rata by all units ($13.33 per unit), including Class B Units issued in Year Two.

- Class B Units issued in Year One are profits interests, generally not taxable to the workers on receipt.
  - On immediate liquidation after the units were received, Class B Units would get none of the $1,000.
  - On liquidation after a year, Class B Units do get $13.33 per unit.
    - These units were profits interests on grant, and only participated in future growth.
Example: Targeted Allocations

– On these facts, Class B Units issued in Year Two are *capital interests*, generally taxable to the workers.
  
  • On immediate liquidation after the units are received, these Class B Units get $13.33 per unit.
  • The right to receive proceeds on a liquidation is the definition of a capital interest.
  • Class B Units issued in Year Two are capital interests; they share in a liquidating distribution even if there is no future profit or growth.
  • All Class B Units had equal distribution rights, but the Year Two Class B Units were taxable capital interests.
Example: Targeted Allocations

- Class B Units issued in Year Two should have had lower distribution rights than Class B Units issued in Year One, the same as in the traditional allocation example.

- It is possible to use targeted allocations even when workers receive profits interests at different times, but exercise care.

  • For example, LLC could have granted only "Class C Units" in Year Two, and provided that Class C Units only share in liquidating distributions over $3,000.

- Regardless of the allocation method, or the labels that are given to the units, profits interests granted at widely different times normally will not have the exact same rights to receive LLC distributions.