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April 11, 2005

Subject: Request for Legal Opinion – Transfers of Limited Liability Company
Membership Interests

Dear Mr. _____ :

This is in reply to your letter of October 24, 2003, which your assistant re-sent to our office on February 1, 2005, in which you request our opinion as to whether payments of a preferred return on capital and distribution of the capital to a limited liability company (LLC) member resulted in a transfer of more than 50 percent of the capital interest and 50 percent of the profits interests in the other LLC to the other member. In that event, the other member would obtain a majority ownership interest in the LLC, and result in a change in ownership of real property owned by the LLC. As set forth below, a member's percentage of capital interests is measured by the member's distributive share of partnership equity and a member's percentage of profits interest is measured by the actual profits recorded at the end of the year. Your letter did not provide sufficient facts for us to make a majority ownership interest determination but an application of our analysis and conclusion should enable you to make that determination.

Facts Presented

H and L are the members of a LLC that owns real property in California. The Amended and Restated LLC Agreement (Agreement) establishes the rights and obligations of the members and provides that H made an initial capital contribution in the amount of \$10,000,000 and L made an initial capital contribution in the amount of \$1,000 in 1998. During 1998, H contributed an additional \$125,000 and L contributed an additional \$9,990,000 and had a profit of \$136. At year end 1998, H's capital account was \$10,125,000 and L's capital account was \$10,000,136.

Under the terms of the Agreement, L is paid an annual minimum cumulative preferred return of 10 percent on Preferred Capital provided by L and is paid an annual minimum cumulative preferred return of 2 percent on all Preferred Capital provided by L but this 2 percent return is payable only out of and to the extent of profits. L is also repaid all Preferred Capital provided by L and upon payment of the preferred returns to L and

repayment in full of all Preferred Capital, the interest in the LLC represented by the Preferred Capital would be extinguished. Any profits of the LLC are allocated 100 percent to H after the payment of the 10 percent and 2 percent preferred returns to L. Losses are allocated 100 percent to H until H's capital account is exhausted and then to L until L's capital account is exhausted and thereafter in accordance with federal tax laws.

Through 2002, LLC profits have been allocated to L in the amount of the preferred return and losses have been allocated 100 percent to H. For each of the years ending 1998, 1999, 2000, and 2001, H's capital account balance exceeded L's capital account balance. In 2002, H was allocated a large loss and, as a result, L's capital account at the end of year 2002 exceeded H's capital account balance. As of April 2003 L's capital contribution of \$10 million plus a preferred return of \$5,433,333 has been distributed to L in full and L currently has a zero interest in LLC capital and profits. The parties wish to remove L as a member so that H will remain as the sole member of the LLC.

Law and Analysis

Initially, you contend that L's contribution constitutes a loan but that the transaction was structured as a contribution of capital and acquisition of a LLC membership interest to avoid legal issues that might arise if L made a direct loan. Thus, you conclude that H always held 100 percent of the capital and profits interests in the LLC and the loan has now been paid off with interest by the return of L's capital contribution and payment of a preferred return. However, under the facts presented, L is described as a member of the LLC and our analysis will be limited to those facts absent any evidence to the contrary. If you have other information such as income tax returns showing that the preferred returns were deductible as interest by the LLC, we would consider it and revise our opinion, if necessary. We further note that, for federal income tax purposes, an amount advanced as a "loan" is likely to be characterized as an equity contribution and the "lender" will be treated as a partner if there is no unconditional promise to repay the advance either on demand or at a time certain. 1 McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶3.03[3] (2002)

With respect to a legal entity, such as a LLC, the transfer of ownership interests generally does not result in a change in ownership of the real property owned by the legal entity pursuant to Revenue and Taxation Code section 64, subdivision (a). However, one of the exceptions to that provision, subdivision (c) of section 64 provides that

(c) When a corporation, partnership, limited liability company, other legal entity, or any other person obtains control through direct or indirect ownership or control of more than 50 percent of the voting stock of any corporation, or obtains a majority ownership interest in any partnership, limited liability company, or other legal entity through the purchase or transfer of corporate stock, partnership, or limited liability company interest, or ownership interests in other legal entities, including any purchase or transfer of 50 percent or less of the ownership interest through which control or a majority ownership interest is obtained, the purchase or transfer of that stock or other interest shall be a change of ownership of the real property owned by the corporation, partnership, limited liability company, or other legal entity in which the controlling interest is obtained.

Rule 462.180 is the regulation that interprets and implements section 64 and subdivision (d)(1)(A) defines majority ownership interest in a partnership or limited liability company as “direct or indirect ownership of more than 50 percent of the total interest in partnership or LLC capital and more than 50 percent of the total interest in partnership or LLC profits”. As subdivision (d)(1)(A) indicates, partnership and LLC capital and profits are treated the same for majority ownership interest determinations and, thus, a definition of partnership capital and profits would also apply to LLC capital and profits. However, neither the statute nor the regulation defines partnership capital and profits interests for purposes of a majority ownership interest determination.

Under federal income tax law, partnership capital and profits interests are counted for purposes of determining a sale or exchange of those interests above a stated amount. Internal Revenue Code section 708(b)(1)(B) provides that a partnership terminates if 50 percent or more of the total interest in partnership capital and profits is sold or exchanged within a 12-month period. A selling partner’s capital interest is defined as equal to the portion of the partnership’s equity that would be distributable to the partner upon a hypothetical sale of all partnership assets for their fair market value, satisfaction of all partnership liabilities, and liquidation of the partnership. 1 McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* ¶12.03[2][a] (2002). Thus, a partner’s capital interest will vary according to the fair market value of the partnership assets less the satisfaction of all partnership liabilities and liquidation of the partnership.

In our view, the definition of partnership capital as a portion of the partnership’s equity is applicable for change in ownership purposes. Equity is defined as “an ownership right in property”. Merriam-Webster’s Collegiate Dictionary, Tenth Edition (2000) p. 392. Thus, the partner’s share of the ownership rights in the partnership’s property constitutes the partner’s capital interest for federal income tax purposes. Likewise, under section 64, subdivision (c), a change in ownership is determined by the transfer of a majority of the partners’ ownership interests to a single person or entity. Because partnership capital for federal income tax purposes is predicated on an ownership interest in the partnership, it is an appropriate definition for determining whether a partner or a member of a LLC has obtained a majority ownership interest in a partnership or LLC for change in ownership purposes.

Under the facts presented, we have no information to determine the fair market value of the LLC assets so as to conclude that H’s distributive share of the LLC equity constituted a capital interest of more than 50 percent in each year. H was allocated 100 percent of the losses thereby reducing H’s capital account balance in 2002. However, if H was also allocated a certain percentage of the gain and the fair market value of the LLC’s assets had appreciated or remained unchanged in 2002 then the amount of the unrealized gain inherent in the LLC’s assets would be credited to H’s capital account. Thus, if the unrealized gain allocated to H offset the loss allocated to H in 2002 such that H’s capital interest at year end 2002, which would include the unrealized gain, was greater than L’s capital interest, then H’s distributive share of the LLC assets upon liquidation would be greater than L’s distributive share. As a result, H would have a majority ownership interest in the LLC at year-end 2002 even though H’s capital account balance reflected a lower dollar amount than L’s capital account balance.

Unlike the capital interest, profits interests are not defined for purposes of Internal Revenue Code section 708(b)(1)(B). However, it is our view that the percentages of the members' profits interests would also be determined as of the end of the year based on the total amount of partnership profits. After payment of L's 10 percent minimum annual cumulative preferred return and 2 percent cumulative preferred return to the extent of remaining profits, H has a 100 percent interest in the LLC profits. Accordingly, the respective profits interest percentages of H and L will vary with the level of total LLC profits each year because H receives an interest in the profits only after L is paid the preferred returns. The greater the total LLC profits, the smaller will be L's percentage interest. For example, if the LLC has profits of \$200,000 and L's preferred returns are \$100,000 then H has a 50 percent profits interest and L has a 50 percent profits interest. If profits of the LLC increase to \$500,000 and L's preferred returns are \$100,000 then H has an 80 percent profits interest that year and L has a 20 percent profits interest.

The opinions expressed in this letter are only advisory and represent the analysis of the legal staff of the Board based on current law and the facts set forth herein. These opinions are not binding on any person or public entity.

Very truly yours,

/s/ Lou Ambrose

Lou Ambrose
Acting Assistant Chief Counsel

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