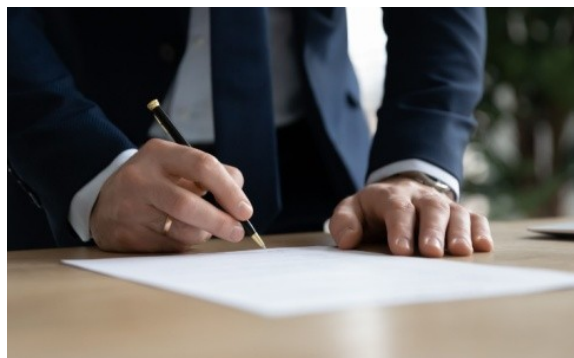


Operating Agreements – One Size Does Not Fit All

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By Scott K. Tippet



A recent private letter ruling highlights the danger of using a form or template blindly. PLR 202219005 involved a limited liability company (the “Company”) that sought, but failed, to be taxed as an S-corporation. On the effective date of the Company’s organization, the Company duly adopted a written operating agreement. The problem was the written operating agreement contained provisions appropriate for partnerships but not S-corporations. Specifically, one provision of the operating provided, “the proceeds from liquidation will be allocated to members with positive balances in their respective capital accounts, pro-rata, in proportion to the positive balances in those capital accounts.”

Provisions like this one are seen routinely in operating agreements for entities taxed as partnerships for federal income tax purposes but are wholly inappropriate for entities taxed as S-corporations. Recall an S-corporation may have only one class of stock. While an S-corporation can have voting and non-voting shares, all shares must have identical rights to distribution and liquidation proceeds. The problem is partnership allocation provisions, such as the one at issue here, do not confer identical rights to distribution and liquidation proceeds.

More of a problem among the DIY community who grab forms off the internet; this also can happen with attorneys who create limited liability companies (and operating agreements for those LLCs) without understanding what the agreements actually say and do. The allocation and distribution provisions of an operating agreement are the meat of the agreement because these provisions determine how members get money (or don’t get it) (distributions) and how they are taxed on money (or not taxed) (allocations). You don’t go to your dentist for heart surgery, and you don’t go to your cardiologist to fill a tooth. Lawyers are the same. When setting up a new company, turn to a lawyer well-versed in business and tax matters.

The PLR does not discuss how the operating agreement came to contain partnership tax allocation provisions, only that it did. This PLR serves as a cautionary tale – **do not use forms blindly**. With operating agreements, one size DOES NOT fit all. Each operating agreement should be tailored to the facts and circumstances of the particular transaction and the parties’ intended tax treatment. In the case the Company was fortunate, the Service granted relief. Still, the need for (and cost of) a PLR easily could have been avoided had the taxpayer carefully reviewed the operating agreement.

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