The Top 10 Tax Errors Made in Partnership and LLC Agreements and How to Avoid Them

Presented by

😂 WealthCounsel

Thought Leader Series

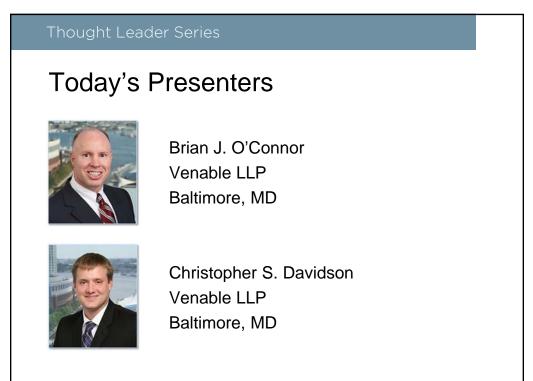
# Today's Moderator



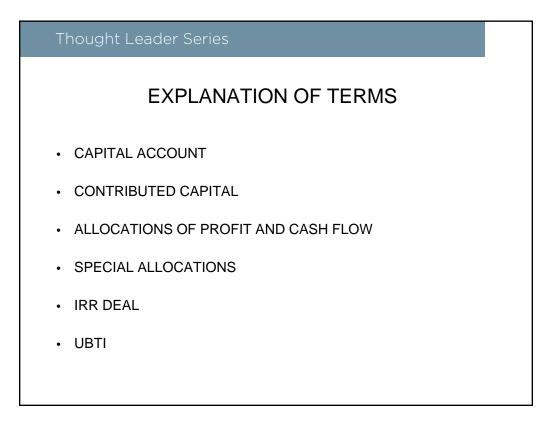
Jerry Touslee VP, Marketing for WealthCounsel Colorado

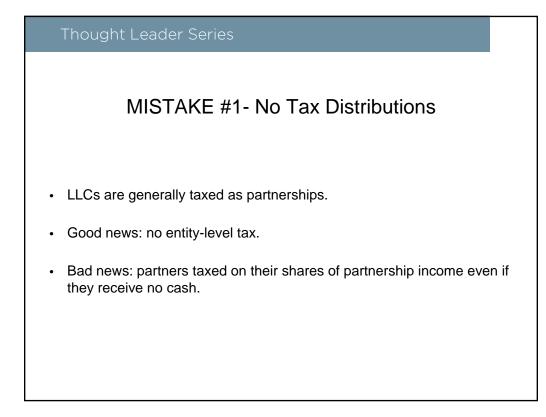














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MISTAKE #1 (cont'd)
Tax Distributions are particularly important for:
LLC members without control of distributions.
<ul> <li>LLC members with little contributed capital when the LLC is using most cash flow to return capital contributions.</li> </ul>
<ul> <li>LLC members in LLCs focused on aggressively paying down entity- level debt.</li> </ul>

Business Docx				
Tax <mark>M</mark> atters				
	Tax Classification			
The Company is t	axed as a:			
Partnership	\$			
	Distributions for Tax Liabilities			
Must the Compa	ny make distributions to the Members to help pay the Members's tax liability?			
💿 Yes 🔿 No	에는 이상,			
The Company m	ist make distributions for taxes at least days before the date on which the estimated quarterly tax payment is due			
5				
1				
Pucinoco	Dooy allows the user to require that the LLC makes toy			
Dusiness	Docx allows the user to require that the LLC makes tax			
	ac Danatit' Enables the dratter to suctomize the timing of tay			
	ns. Benefit: Enables the drafter to customize the timing of tax ns to meet a client's needs			



Business Docx				
f tax advances to a Me ear.	ember are insufficient to cover the Member's tax liability, the Company must make shortfall distributions within days after the end of the taxable			
75				
or purposes of deter	nining the amount of tax withholding, a Member's tax rate will be assumed to be: 🏮			
sometimes used to o	(New York City) is often considered to have the highest blended federal, state, and local tax rate in the country. Because of this, New York City is alculate tax distributions when the parties want to ensure larger distributions for tax liability. If you choose New York, New York, the Members will h tax distributions, but calculation may be more difficult for the Company's accountant.			
The highest margin	al blended federal, state, and local tax rate for an individual residing in New York, New York			
) The highest margin	al blended federal, state, and local tax rate for an individual residing in Virginia			
Stated percentage				
istributior	Docx provides a number of options for structuring tax ns, including how to calculate the rate that will be used to ne tax liability. <i>Benefit: Allows the drafter to select an</i>			

MISTAKE #2 - If Liquidating with Capital Accounts, Allocating Profits to Follow Repayments of Capital

Example: A and B form a 50/50 LLC.

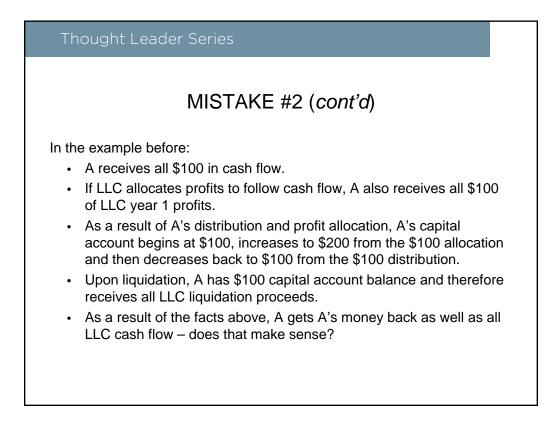
A contributes \$100 and B contributes \$0.

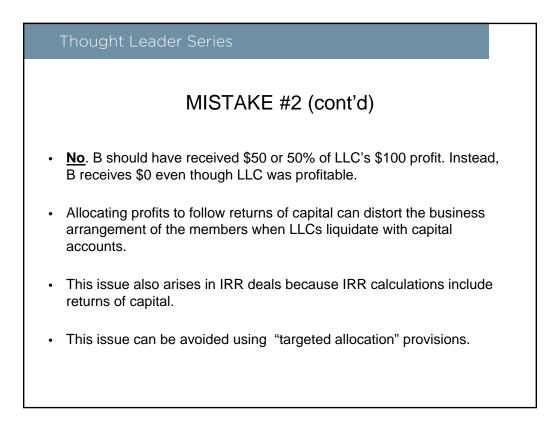
Under their business arrangement, the LLC will return A's capital first and then make distributions on a 50/50 basis. LLC will liquidate based on positive capital accounts.

In the LLC's first year, it produces \$100 of profit and cash flow. LLC distributes the cash to A.

In LLC's second year, LLC liquidates its remaining \$100 in assets to its members according to their positive capital account balances.









# MISTAKE #3 - If Liquidating with Capital Accounts, Letting the Tax Regulatory Allocations Upset Your Business Deal

- The "Tax Regulatory Allocations" are tax allocations necessary to meet the IRC Section 704(b) safe harbor.
- Sometimes the Tax Regulatory Allocations move income or deductions in a manner that is inconsistent with the business deal.
- When an LLC liquidates with capital accounts, such movements can impact the economics of the deal in a manner that is unintended by the members.

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## MISTAKE #3 (cont'd)

**Example**: Assume A and B form LLC with A contributing \$100 and B contributing \$10.

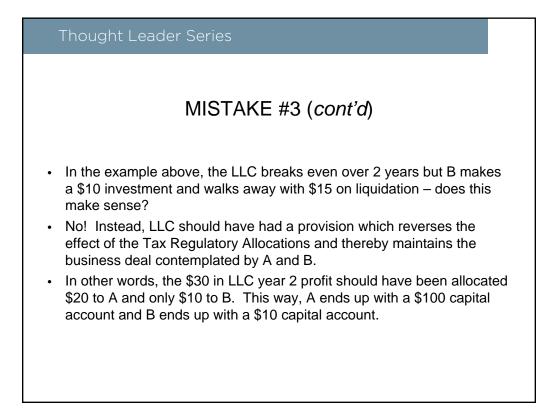
A and B agree to share all profits and losses 50/50.

In year 1, LLC incurs a \$30 loss. Ordinarily, this loss would be shared \$15 each by A and B. However, because B has only a \$10 capital account, only \$10 of the \$30 loss can be allocated to B. The remaining \$20 must be allocated to A.

In year 2, LLC produces \$30 of profit which A and B share \$15 each. As a result, A's capital account begins at \$100, is reduced to \$80 and then increases to \$95. B's capital account, on the other hand, starts at \$10, is reduced to \$0 and then increases to \$15.

After year 2, LLC liquidates according to positive capital accounts.

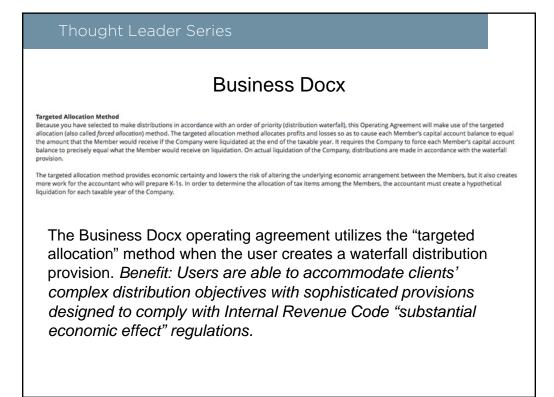




MISTAKE #4 - Not Liquidating with Capital Accounts when the Members Desire Special Allocations or when a Member is a Pension Plan in a Real Estate Deal

- In most cases, to make special allocations effective for tax purposes, LLCs will have to liquidate with positive capital accounts and satisfy the IRC Section 704(b) safe harbor.
- In order for a pension plan to avoid UBTI in a real estate LLC, the LLC often must satisfy the "fractions rule" under IRC Section 514. To satisfy the fractions rule, the LLC must liquidate with capital accounts.

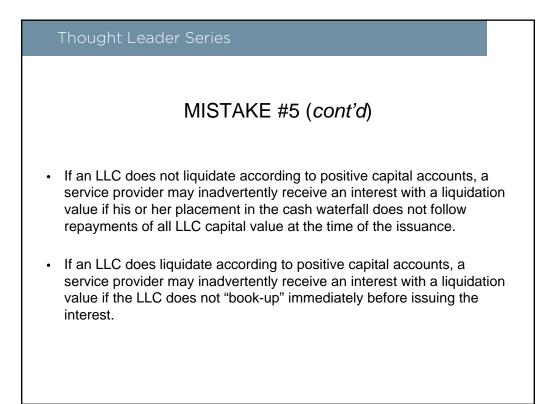




MISTAKE #5 - Creating a Taxable Event for Service Providers who are Intended to Receive Nontaxable Profits Interests

- Under Rev. Procs. 93-27 and 2001-43, service providers generally can receive profits interests in entities taxed as partnerships on a tax-free basis.
- To qualify an interest as a profits interest under the Rev. Procs., the interest must have no "liquidation value" at the time of issuance.
- An LLC interest has no liquidation value if member would receive no proceeds from a sale by the LLC of all of its assets immediately after issuance of the interest.





Business Docx				
	Equity Structu	ure		
Select the Company's	equity structure:			
The Company will	issue a single class of Interests with no differences in voting or economi	ic rights		
All Members will h	ave equal economic rights, but there will be both Voting and Non-Voting	g Members		
The Company will	issue multiple classes of Interests with differing economic and voting rig	ghts		
In addition to Commo (select all that apply) *	on Interests, the Company is authorized to issue what types of Interests	?		
Preferred Inter	ests - Interests that entitle the holder to distribution preferences.			
Incentive Interest	sts - non-voting Interest provided to a Service Provider as compensation	n.		
Does the Operating A	greement limit the number of Incentive Interests?			
lesigned to qua Benefit: Users a	allows users to create an "incentive interest" that i lify as a profits interest that is not taxable upon re are able to confidently incorporate complex equity gned to meet client's economic and tax objectives	eceipt.		



# MISTAKE #6 - Providing Too Much Power to the Tax Matters Member ("TMP") when the TMP is Not Your Client

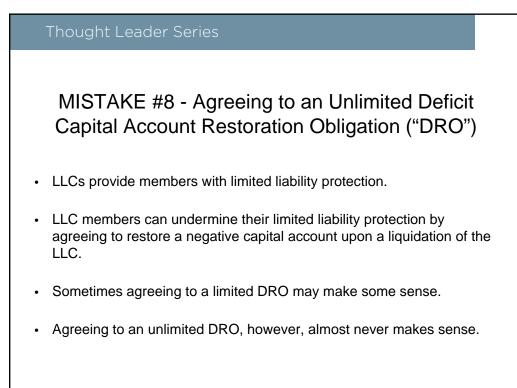
- The TMP has to have certain powers related to interfacing with the IRS in the event of an audit.
- The TMP, however, does not have to have the power to make LLC tax elections or make final decisions related to the LLC's tax return.
- Unless the TMP is your client, you should not unnecessarily assign powers and rights to the TMP.

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MISTAKE #7 - Limiting Transfers Potentially Causing a Technical Termination when Your Client Holds a 50% or Greater LLC Interest

- LLC Agreements generally limit transfers of LLC interests by members.
- Some Agreements forbid transfers that potentially could cause a technical tax termination under IRC Section 708(b)(1)(B) (that is, transfers of 50% of more of the overall LLC interests within a 12 month period).
- Often, the consequences of a technical termination are tolerable.
- Thus, if your client owns a 50% or greater interest, forbidding a transfer that could cause a termination may not make sense.

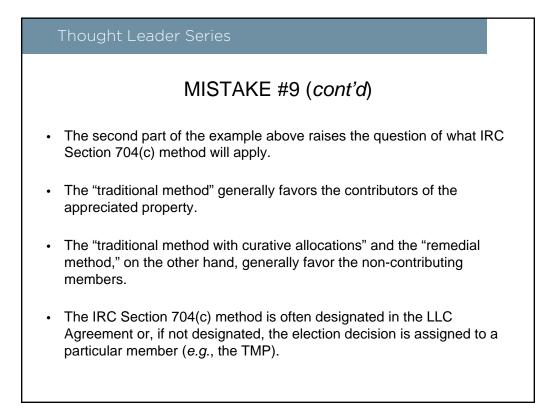


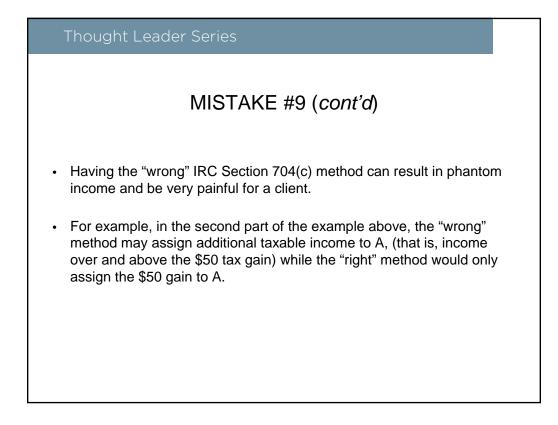


# MISTAKE #9 - Not Paying Sufficient Attention to IRC Section 704(c) Methods

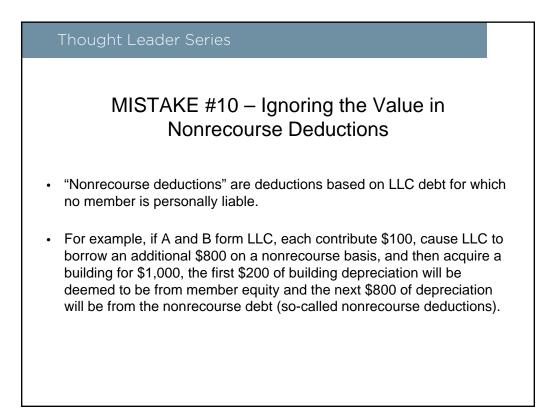
- IRC Section 704(c) severely limits the ability of LLC members to shift items of built-in gain and built-in loss among themselves.
- For example, if A contributes property with a value of \$100 and a tax basis of \$40 to LLC and LLC subsequently sells the property for \$100, IRC Section 704(c) requires that the LLC allocate the \$60 of gain from the sale back to A.
- If the LLC subsequently sells the property in the example above for \$90, LLC will incur a \$10 "book loss" while also incurring a \$50 "tax gain." The \$50 of tax gain must be allocated to A. What about the \$10 book loss?

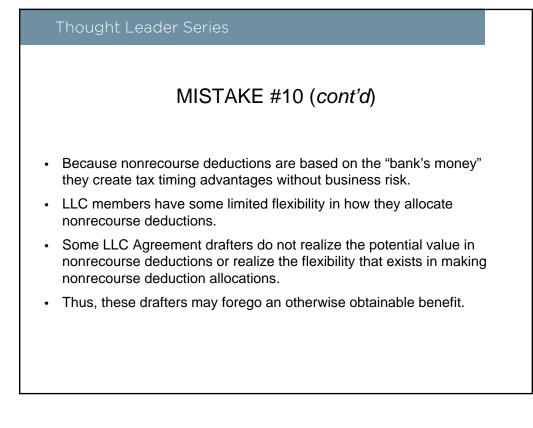














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