Thought Leader Series

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

Presented by

Thought Leader Series

Today's Moderator

Jerry Touslee

VP, Marketing for WealthCounsel

Colorado

Thought Leader Series

- **Thought Leadership and CLE**: comprehensive curriculum of webinars and virtual education ALL included in the value of membership
- **Practice Development**: coaching programs and law business mentoring, monthly marketing packages, digital marketing content and tools
- **Wealth Docx™ and Business Docx™**: the nation's leading document drafting software solutions for trusts and estates and small business planning, with new content added regularly and input from our member community
- **Community of 4,000+ attorneys**: build relationships, get helpful answers and advice, network and share your experiences
- Gain more insights at WealthCounsel.com

Thought Leader Series

Today's Presenters

Brian J. O'Connor
Venable LLP
Baltimore, MD

Christopher S. Davidson
Venable LLP
Baltimore, MD

EXPLANATION OF TERMS

- CAPITAL ACCOUNT
- CONTRIBUTED CAPITAL
- ALLOCATIONS OF PROFIT AND CASH FLOW
- SPECIAL ALLOCATIONS
- IRR DEAL
- UBTI

MISTAKE #1- No Tax Distributions

- LLCs are generally taxed as partnerships.
- Good news: no entity-level tax.
- Bad news: partners taxed on their shares of partnership income even if they receive no cash.

Thought Leader Series

MISTAKE #1 (*cont'd*)

Tax Distributions are particularly important for:

- LLC members without control of distributions.
- LLC members with little contributed capital when the LLC is using most cash flow to return capital contributions.
- LLC members in LLCs focused on aggressively paying down entity-level debt.

Thought Leader Series

Business Docx

Tax Matters

Tax Classification

The Company is taxed as a:

Partnership

Distributions for Tax Liabilities

Must the Company make distributions to the Members to help pay the Members's tax liability?

(•) Yes ( ) No

The Company must make distributions for taxes at least ___ days before the date on which the estimated quarterly tax payment is due.

5

Business Docx allows the user to require that the LLC makes tax distributions. *Benefit: Enables the drafter to customize the timing of tax distributions to meet a client's needs.*

Business Docx

If tax advances to a Member are insufficient to cover the Member's tax liability, the Company must make shortfall distributions within ___ days after the end of the taxable year.

75

For purposes of determining the amount of tax withholding, a Member's tax rate will be assumed to be:

New York, New York (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 sometimes used to calculate tax distributions when the parties want to ensure larger distributions for tax liability. If you choose New York, New York, the Members will receive relatively high tax distributions, but calculation may be more difficult for the Company's accountant.

- (selected) The highest marginal blended federal, state, and local tax rate for an individual residing in New York, New York
- The highest marginal blended federal, state, and local tax rate for an individual residing in Virginia
- Stated percentage

Business Docx provides a number of options for structuring tax distributions, including how to calculate the rate that will be used to estimate the tax liability. *Benefit: Allows the drafter to select an appropriate tax rate tailored to the members' location and other relevant circumstances.*

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 #2 (*cont'd*)

In the example before:

- A receives all $100 in cash flow.
- If LLC allocates profits to follow cash flow, A also receives all $100 of LLC year 1 profits.
- As a result of A's distribution and profit allocation, A's capital account begins at $100, increases to $200 from the $100 allocation and then decreases back to $100 from the $100 distribution.
- Upon liquidation, A has $100 capital account balance and therefore receives all LLC liquidation proceeds.
- As a result of the facts above, A gets A's money back as well as all LLC cash flow – does that make sense?

MISTAKE #2 (cont'd)

- **No**. B should have received $50 or 50% of LLC's $100 profit. Instead, B receives $0 even though LLC was profitable.
- Allocating profits to follow returns of capital can distort the business arrangement of the members when LLCs liquidate with capital accounts.
- This issue also arises in IRR deals because IRR calculations include returns of capital.
- This issue can be avoided using "targeted allocation" provisions.

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.

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 #3 (*cont'd*)

- In the example above, the LLC breaks even over 2 years but B makes a $10 investment and walks away with $15 on liquidation – does this make sense?
- No! Instead, LLC should have had a provision which reverses the effect of the Tax Regulatory Allocations and thereby maintains the business deal contemplated by A and B.
- In other words, the $30 in LLC year 2 profit should have been allocated $20 to A and only $10 to B. This way, A ends up with a $100 capital account and B ends up with a $10 capital account.

Thought Leader Series

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.

Thought Leader Series

Business Docx

Targeted Allocation Method

Because you have selected to make distributions in accordance with an order of priority (distribution waterfall), this Operating Agreement will make use of the targeted allocation (also called *forced allocation*) method. The targeted allocation method allocates profits and losses so as to cause each Member's capital account balance to equal the amount that the Member would receive if the Company were liquidated at the end of the taxable year. It requires the Company to force each Member's capital account balance to precisely equal what the Member would receive on liquidation. On actual liquidation of the Company, distributions are made in accordance with the waterfall provision.

The targeted allocation method provides economic certainty and lowers the risk of altering the underlying economic arrangement between the Members, but it also creates more work for the accountant who will prepare K-1s. In order to determine the allocation of tax items among the Members, the accountant must create a hypothetical liquidation for each taxable year of the Company.

The Business Docx operating agreement utilizes the "targeted allocation" method when the user creates a waterfall distribution provision. *Benefit: Users are able to accommodate clients' complex distribution objectives with sophisticated provisions designed to comply with Internal Revenue Code "substantial economic effect" regulations.*

Thought Leader Series

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.

MISTAKE #5 (*cont'd*)

- If an LLC does not liquidate according to positive capital accounts, a service provider may inadvertently receive an interest with a liquidation value if his or her placement in the cash waterfall does not follow repayments of all LLC capital value at the time of the issuance.
- If an LLC does liquidate according to positive capital accounts, a service provider may inadvertently receive an interest with a liquidation value if the LLC does not "book-up" immediately before issuing the interest.

Business Docx

Equity Structure

Select the Company's equity structure:

- ○ The Company will issue a single class of Interests with no differences in voting or economic rights
- ○ All Members will have equal economic rights, but there will be both Voting and Non-Voting Members
- ● The Company will issue multiple classes of Interests with differing economic and voting rights

In addition to Common Interests, the Company is authorized to issue what types of Interests? *(select all that apply)* *

- ☐ Preferred Interests - Interests that entitle the holder to distribution preferences.
- ☑ Incentive Interests - non-voting Interest provided to a Service Provider as compensation.

Does the Operating Agreement limit the number of Incentive Interests?

○ Yes ● No

Business Docx allows users to create an "incentive interest" that is designed to qualify as a profits interest that is not taxable upon receipt. *Benefit: Users are able to confidently incorporate complex equity provisions designed to meet client's economic and tax objectives.*

Thought Leader Series

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.

Thought Leader Series

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 #8 - Agreeing to an Unlimited Deficit Capital Account Restoration Obligation ("DRO")

- LLCs provide members with limited liability protection.
- LLC members can undermine their limited liability protection by agreeing to restore a negative capital account upon a liquidation of the LLC.
- Sometimes agreeing to a limited DRO may make some sense.
- Agreeing to an unlimited DRO, however, almost never makes sense.

Thought Leader Series

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?

Thought Leader Series

MISTAKE #9 (*cont'd*)

- The second part of the example above raises the question of what IRC Section 704(c) method will apply.
- The "traditional method" generally favors the contributors of the appreciated property.
- The "traditional method with curative allocations" and the "remedial method," on the other hand, generally favor the non-contributing members.
- The IRC Section 704(c) method is often designated in the LLC Agreement or, if not designated, the election decision is assigned to a particular member (*e.g.*, the TMP).

Thought Leader Series

MISTAKE #9 (*cont'd*)

- Having the "wrong" IRC Section 704(c) method can result in phantom income and be very painful for a client.
- For example, in the second part of the example above, the "wrong" method may assign additional taxable income to A, (that is, income over and above the $50 tax gain) while the "right" method would only assign the $50 gain to A.

MISTAKE #10 – Ignoring the Value in Nonrecourse Deductions

- “Nonrecourse deductions” are deductions based on LLC debt for which no member is personally liable.
- For example, if A and B form LLC, each contribute $100, cause LLC to borrow an additional $800 on a nonrecourse basis, and then acquire a building for $1,000, the first $200 of building depreciation will be deemed to be from member equity and the next $800 of depreciation will be from the nonrecourse debt (so-called nonrecourse deductions).

MISTAKE #10 (*cont'd*)

- Because nonrecourse deductions are based on the “bank's money” they create tax timing advantages without business risk.
- LLC members have some limited flexibility in how they allocate nonrecourse deductions.
- Some LLC Agreement drafters do not realize the potential value in nonrecourse deductions or realize the flexibility that exists in making nonrecourse deduction allocations.
- Thus, these drafters may forego an otherwise obtainable benefit.

Brian J. O'Connor
Venable LLP
Baltimore/Washington
410.244.7863
bjoconnor@venable.com

Christopher S. Davidson
Venable LLP
Baltimore, MD
410.244.7780
csdavidson@venable.com

Thought Leader Series

- Presentation slides can be downloaded at www.wealthcounsel.com in the Resource Center

- Share the power of thought leadership! Send a tweet (use #TLSW) or post your thoughts on Facebook or LinkedIn.

www.twitter.com/WealthCounsel
www.facebook.com/WealthCounsel

WealthCounsel
Practice Excellence.

Thought Leader Series

Thank you for attending!

Subscribe to the WealthCounsel Listserv:
http://www.wealthcounsel.com/Solutions/Community/Listservs/

CLE approved or pending in AK, AR, AZ, CA, IL, KS, MT, NJ, NY, OK, PA, TX

Eligible for **CFP** 1.0 credit and 1.0 **CPE** credit (TX). Certificate will be emailed to you.

CE Attendance Verification Code: **tg89g**
This code is for states that need additional proof of attendance. It is not a CLE course number.

Continuing Education questions? cle@wealthcounsel.com

Information about WealthCounsel:
888-659-4069, Ext. #819 or visit us online at www.wealthcounsel.com

Thought Leader Series

Thank you for attending!

Next Thought Leader Series webcast: Tuesday, March 15

WealthCounsel
Practice Excellence.