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2011 LIMITED LIABILITY COMPANY (LLC) & PARTNERSHIP FEDERAL TAX UPDATE

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COURSE OBJECTIVES

- Review Entity Classification Issues
- Is an LLC Member a Limited or General Partner for Self Employment Tax Purposes?
- How to Abandon a Partnership Interest and Receive an Ordinary Loss Deduction
- Review Partnership Operations - Overview
- New Developments
- Economic Substance Doctrine
- YEAR END CPE!!



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CPA EXPORSURE

- According to CAMICO, one of the largest E & O insurance providers, two of the five most common tax related claims against tax preparers are:
 - Wrong Entity Choice
 - Failure to make or document IRC Section 754 election



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ENTITY ISSUES

- Partnership includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is nota corporation or a trust or estate. §761(a) and §7701(a)(2).



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ENTITY ISSUES (CONT'D)

- 24.3 million partnership/LLC's were filed in 2009. 99% were calendar year. 88% were completed by a paid preparer. Only 18% of the returns had five or more partners. 45% of the returns were real estate related activities.
- Why form a Partnership or LLC
 - Investment vs. trade or business
 - Type of investors



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ENTITY ISSUES (CONT'D)

- Why be an LLC and elect corporate taxation:
 - State tax issues (gross receipt fees)
 - LLC liability protection is preferred over corporate liability protection but corporate form of taxation makes more sense
 - Payroll tax savings
 - Employee benefits



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ENTITY ISSUES (CONT'D)

- Check-The-Box Rules
 - Under §301.7701-1 through 301.7701-3 eligible entities are able to choose whether to be taxed as a partnership or corporation for federal tax purposes.
 - File Form 8832
 - Does not have to be filed by Partnership or LLC electing to be taxed as a corporation on initial return
 - File S Election – Form 2553



ENTITY ISSUES (CONT'D)

- Revenue Procedure 2009-41
 - The time period allowed for filing late entity classifications has been greatly extended. In addition IRS has extended relief to entities changing classification elections. Late filing is granted if:
 - The entity failed to obtain its desired initial classification as of the date of formation or failed to obtain the requested change in classification solely because Form 8832 was not timely filed;



ENTITY ISSUES (CONT'D)

- Revenue Procedure 2009-41 (cont'd)
 - Late filing relief granted if:
 - The entity seeking an extension of time to make the classification election:
 - Has not filed a Federal Tax Return for the first year in which the election was intended because the due date has not passed; or
 - Timely filed all required Federal Tax Returns consistent with its requested classification for all of the years the entity intended the classification to be in effect.
 - The entity had reasonable cause for its failure to timely make the entity classification elections; and



ENTITY ISSUES (CONT'D)

- Revenue Procedure 2009-41 (cont'd)
 - Late filing relief granted if:
 - The request for classification is made within 3 years and 75 days of the requested effective date.
 - Late election filing procedures:
 - Entity must file signed and completed Form 8832
 - Write at top of Form 8832 “Filed Pursuant to Rev. Proc 2009-41
 - Attach declaration that the elements for relief have been satisfied and attach statement explaining reason for failure to timely file Form 8832.



ENTITY ISSUES (CONT'D)

- When an entity is reclassified, the underlying legal entity remains the same.
 - An association (taxed as a corporation) elects to be a partnership:
 - Deemed liquidation of assets and liabilities to shareholders with deemed contribution of assets and liabilities into partnership.
 - Deemed corporate liquidation could create corporate level tax.

ENTITY ISSUES (CONT'D)

- Entity reclassification (cont'd)
 - Partnership elects to be an association (taxed as corporation):
 - The Partnership is deemed to contribute its assets and liabilities to the association in exchange for stock of the association.
 - Generally, this transaction will be tax free under §351

ENTITY ISSUES (CONT'D)

- Single Member LLC
 - Disregarded for tax purposes.
 - No separate tax return is required
 - No Federal ID Number required unless entity has payroll and/or other federal excise taxes
 - Reasons for Single Member LLC:
 - Asset protection
 - Isolate liabilities
 - Keeping property separate owned before marriage so not commingled with marital property



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SELF EMPLOYMENT TAX

- Rev. Rul. 69-184. Does not allow a taxpayer considered a partner or LLC Member to be treated as an employee.
- Partnership/LLC must be engaged in a trade or business for Partners/Members distributive share of income to be considered SE income. §1.1402(a)-1(b).
- If trade or business, Partner or Members limited participation in management does not limit SE exposure.

SELF EMPLOYMENT TAX (Cont'd)

- If income is Passive under §469 does not preclude Partner/LLC Member from having SE tax on distributive share if from trade or business.
- If a partner owns a limited partnership interest, such partner's distributive share of the income is not subject to self-employment tax. §1402(a)(13)
 - Unless LP receives a guaranteed payment.

SELF EMPLOYMENT TAX (Cont'd)

- Is an LLC Member a Limited or General Partner for Self-Employment Tax Purposes?
 - Proposed amendment to §1.1402(a)-2; REG-209824-96:
 - An individual will be treated as a LP unless:
 - Member has personal liability for LLC debts;
 - Member has authority to contract on behalf of LLC; or
 - Participates in the LLC trade or business for more than 500 hours during the tax year

SELF EMPLOYMENT TAX

(Cont'd)

- Partners in certain service businesses can never become LP's. §1.1401-2(h)(5).
 - Health
 - Law
 - Engineering
 - Architecture
 - Accounting
 - Actuarial science
 - Consulting
 - Performing arts



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SELF EMPLOYMENT TAX (Cont'd)

- 2012 SE Wage Base:
 - \$110,100
- Planning Opportunity
 - Guaranteed payment for “Reasonable Salary” to Partner/Member
 - Remainder of distributive share of income not subject to SE Tax
 - Treated as income derived on return of assets invested in entity

ABANDONMENT OF A PARTNERSHIP INTEREST

- Revenue Ruling 93-80 and §165(a)
- Abandonment will be treated as an ordinary loss if:
 - Has positive capital account
 - Partner/Member receives nothing in return for interest
 - Surrendered all legal rights in the partnership or LLC
 - Was not previously allocated debt of the partnership or LLC

ABANDONMENT OF A PARTNERSHIP INTEREST (CONT'D)

- Forfeiture of interest can also be treated as an abandonment of interest. Forfeiture occurs when:
 - Failure to make payments under subscription agreement or other required capital calls

OPERATIONAL ISSUES

- Contributions to Capital
- Tax Elections
- Partnership Allocations
- Basis of a Partnership Interest – Debt
- Loss Limitations
- Partnership Distributions
- Transactions Between Partnership and Their Partners
- Sale of Partnership Interest

OPERATIONAL ISSUES (CONT'D)

- Optional Basis Adjustments (§754 Election)
- Payments to Retiring Partners



CONTRIBUTIONS TO CAPITAL

- §721

- Generally, Partners or Partnerships do not recognize gain or loss when property is contributed for capital interests:

- Carryover basis in assets to Partnership
- Carryover holding period to Partnership
- Substituted basis for interest in Partnership

- Exceptions:

- Transaction is essentially a taxable exchange of properties;
- Transaction is a disguised sale of properties; or
- Interest is received in exchange for services



TAX ELECTIONS

- Tax Accounting Elections – Partnership
 - Partnership makes elections involving the following items. Elections include:
 - Inventory method
 - Accounting method
 - Cost recovery methods and assumptions
 - Tax year
 - Amortization of organizational costs and period
 - Amortization of start up costs and period
 - Optional basis adjustments for property (§754)
 - Section 179 deductions



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TAX ELECTIONS (CONT'D)

- Tax Accounting Elections – Partners
 - Each Partner individually is required to make specific elections for the following:
 - Whether to reduce the basis of depreciable property first when excluding income from discharge of indebtedness.
 - Whether to claim cost or percentage depletion for oil and gas wells.
 - Whether to take a deduction or a credit for taxes paid to foreign countries and U.S. possessions.



PARTNERSHIP ALLOCATIONS

- Economic Effect. Partner bears economic burden and benefit from allocations.
 - In general, the economic effect test requires the following:
 - An allocation of income or gain to a partner must increase the Partner's capital account, and an allocation of deduction or loss must decrease the Partner's capital account.
 - When the Partner's interest is liquidated, the Partner must receive net assets that have a fair market value equal to the positive balance in the capital account.

PARTNERSHIP ALLOCATIONS (CONT'D)

- Economic Effect (§1.704-1(b))
 - In general, the economic effect test requires the following (cont'd)
 - A Partner with a negative capital account must restore that account upon liquidation of the interest. Restoration of a negative capital account can best be envisioned as a contribution of cash to the Partnership equal to the negative balance.

PARTNERSHIP ALLOCATIONS (CONT'D)

- Precontribution Gain or Loss
 - Must be allocated among the Partners to take into account the variation between the basis of the property and its fair market value on the date of the contribution. §704(c)(1)(A).
 - For nondepreciable property built-in gain or loss on the date of contribution must be allocated to the contributing Partner when the property is eventually disposed of by the Partnership in a taxable transaction.
 - Depreciable property – Other Partners are allocated book depreciation.

BASIS OF A PARTNERSHIP INTEREST - DEBT

- Liability Sharing
 - Recourse debt – Personal liability
 - Nonrecourse debt – No personal liability
 - Under §752
 - An increase in a Partner's share of partnership debt is treated as a cash contribution by the Partner to the Partnership.
 - A decrease in a Partner's share of Partnership debt is treated as a cash distribution from the Partnership to the Partner.
 - Assumption of the Partner's debt by the Partnership

BASIS OF A PARTNERSHIP INTEREST – DEBT (CONT'D)

- Recourse debt is shared in accordance with a constructive liquidation scenario. Under this scenario, the following events are deemed to occur at the end of each taxable year of the Partnership:
 - Most Partnership assets (including cash) become worthless.
 - Worthless assets are sold at fair market value (\$0), and losses on the deemed sales are determined.

BASIS OF A PARTNERSHIP INTEREST – DEBT (CONT'D)

- Allocation of recourse debt (cont'd):
 - Losses are allocated to the Partner's according to their loss sharing ratios.
 - Any Partner with a (deemed) negative capital balance is treated as contributing cash to the Partnership to restore negative balance to zero.
 - Deemed cash contributions are used to pay Partnership liabilities.
 - Represents share of recourse liabilities.

BASIS OF A PARTNERSHIP INTEREST – DEBT (CONT'D)

- Nonrecourse debt is allocated in three stages:
 - Share of Partner's minimum gain
 - Minimum gain equals excess of non recourse liability over the book basis of the property contributed to the Partnership.
 - Allocation based on terms of Partnership Agreement.
 - Next to share of precontribution gain under §704 of contributing Partner.
 - Remainder in most cases allocated based on profit sharing ratios.



LOSS LIMITATIONS

- §704(d). This limitation allows the deduction of losses only to the extent the Partner has adjusted basis for the Partnership interest.
- Losses that are deductible under the overall limitation may then be subject to the at-risk limitation of §465.
- Any losses that survive the second limitation may be subject to a third limitation, the passive loss rules of §469.



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LOSS LIMITATIONS

- §465. At-Risk Rules:
 - Does not include Partner's share of nonrecourse liabilities.
 - Exception is real estate nonrecourse financing provided by a bank, retirement plan, or similar party or by a Federal, state or, local government.

PARTNERSHIP DISTRIBUTIONS

- In a Partnership, it is not critical that all Partners receive a distribution at the same time as long as capital account balances are maintained and final distributions are in accordance with ending capital account balances.
- Distributions may consist of cash or Partnership property.

PARTNERSHIP DISTRIBUTIONS (CONT'D)

- Types of Partnership distributions:
 - Liquidating distributions
 - Nonliquidating distributions
 - Distribution from a continuing Partnership to a continuing Partner.
- Gain recognition on nonliquidating distribution. §731(a)(1).
 - Gain recognized only to the extent cash (and marketable securities) received exceeds outside basis of the Partner's interest in the Partnership.

PARTNERSHIP DISTRIBUTIONS (CONT'D)

- Loss recognition on nonliquidating distribution.
 - The distributee Partner cannot recognize a loss on a proportionate nonliquidating distribution.
- Property distributions
 - In general, a distributee Partner does not recognize gain from a property distribution.
 - Substituted basis in asset if asset basis exceeds basis in Partnership interest.

PARTNERSHIP DISTRIBUTIONS (CONT'D)

- Ordering Rules:
 - When the inside basis of the distributed assets exceeds the distributee Partner's outside basis, the assets are deemed distributed in the following order:
 - Cash
 - Unrealized receivables and inventory
 - All other assets

TRANSACTIONS BETWEEN PARTNERSHIPS AND THEIR PARTNERS

- If a partner engages in a transaction with a Partnership other than in his capacity as a member of such Partnership, the transaction shall.....be considered as occurring between the Partnership and one who is not a Partner. §707(a).

TRANACTIONS BETWEEN PARTNERSHIPS AND THEIR PARTNERS (CONT'D)

- A payment by a Partnership to a Partner who has performed services or furnished property maybe on of three things:
 - A distributive share of Partnership income;
 - A guaranteed payment, subject to §707(c); or
 - A §707(a) payment. Payment to a Partner not acting in his capacity as a Partner .

SALE OF A PARTNERSHIP INTEREST

- The Seller
 - Amount realized includes seller's share of Partnership liabilities
 - Section 751(a) hot assets
 - Taxation of look-through gains under §1(h)

SALE OF A PARTNERSHIP INTEREST (CONT'D)

- The Buyer's Outside and Inside Basis
 - The buyer's outside basis is cost basis under §1012 and includes buyer's share of Partnership liabilities under §752(d).
 - The buyer's inside basis can be equal to outside basis if the Partnership has or will make an election under §754 to adjust basis of assets under §743(b).

SALE OF A PARTNERSHIP INTEREST (CONT'D)

- Collateral Effects of a Sale of a Partnership Interest
 - Allocation of distributive shares of the seller and buyer to take into account the varying interests of the Partners in the Partnership during the taxable year. §706(d)(1).
 - Partnership termination under §708(b).
 - A Partnership terminates if “within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in Partnership capital and profits.” §708(b)(1)(B).

OPTIONAL BASIS ADJUSTMENTS (§754 ELECTION

- Election is to step-up (or step-down) the inside basis of Partnership assets to reflect the purchase price paid by the purchasing Partner.
 - Election made by attaching statement to a timely filed Partnership return (including extensions).
 - Once election is made it is binding on future transactions, unless IRS consents to its revocation.

OPTIONAL BASIS ADJUSTMENTS (§754 ELECTION)

- Type of transactions giving rise to optional basis adjustments:
 - Sale or exchange of an interest. §743(b).
 - Partnership distributions. §734(b).

PAYMENTS TO RETIRING PARTNERS

- Payments to Retiring Partners
 - §736(a) payments – Payment that is not for a Partner's interest in Partnership property.
 - Payment of a distributive share if amount is depends upon the Partnership's income
 - Fixed payment is treated as a guaranteed payment.
 - §736(b) payments – Payment for interest in Partnership property.
 - §736 payments are distributions.

PAYMENTS TO RETIRING PARTNERS (CONT'D)

- How §736 Payments are Taxed
 - Fixed in amount (guaranteed payment) taxed as ordinary income to the Partner
 - If payment depends on net income of the Partnership, payments are taxed as distributive shares to the Partner.
 - If payment is a distribution under §736(b)
 - Unrealized receivables and appreciated inventory taxed under §751(b).
 - Otherwise tax treatment depends on §731, 732 and 733.

PAYMENTS TO RETIRING PARTNERS (CONT'D)

- Liquidation of an Entire Partnership
 - §736 is drafted under the assumption that the Partnership would continue to exist after the distributee's interest had been liquidated.
 - If Partnership ceased to exist then each Partner has received a distribution and §736 does not apply.

OTHER DEVELOPMENTS

- Economic Substance
- Non-Compensatory Options
- Anti-Abuse Rule under §704(c)
- Partnership Tax Return Filing Extensions
- Summons on LLC
- Tax Matters Partner Authority
- Partner Statute of Limitations for Partnership Items
- Revenue Ruling 99-6.

ECONOMIC SUBSTANCE DOCTRINE (CONT'D)

- Under new §7701(o):
 - ES doctrine must be relevant to the transaction
 - Transaction will have economic substance only if:
 - It changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position; and
 - The taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

ECONOMIC SUBSTANCE DOCTRINE

- Codified in new §7701(o)
- Applicable to transactions entered into after March 30, 2010
- According to JCT Report, new §7701(o) “clarifies and enhances” the ES doctrine but “does not alter the flexibility of the courts in other respects.”

ECONOMIC SUBSTANCE DOCTRINE (CONT'D)

- What is the ES Doctrine?
 - Denies tax benefits
 - Transactions that meet literal terms of tax code
 - Transactions lack economic substance or business purpose

ECONOMIC SUBSTANCE DOCTRINE (CONT'D)

- Why is codification of ES doctrine significant?
 - New 40% penalty on underpayment attributable to transactions that lack economic substance or fail to meet requirements of “any similar rule of law.” §6662(b)(6), (i)
 - 40% penalty reduced to 20% if relevant facts affecting the tax treatment are disclosed in the return
 - No reasonable-cause defense. §6664(c)(2).

ECONOMIC SUBSTANCE DOCTRINE (CONT'D)



- What is a relevant transaction subject to the ES doctrine.



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