



Partnerships and LLCs – Understanding a Popular but Complex Entity Choice

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Agenda

- What are partnerships?
- Considerations for partnership transactions
- Hot industries for partnerships

Poll question

What is a “partnership”?

- Two or more persons or corporations joined together in a common business venture for profit in which there is a risk of loss
- 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 not, a corporation, trust or estate
- A business entity specifically guided by the provisions of Subchapter K of the Internal Revenue Code
- A domestic “eligible entity” as defined in Treas. Reg. Section 301.7701-3 that has more than one owner and does not make an election to be treated as an association on a Form 8832
- All of the above

Definition of a partnership

- IRC sections 761(a) and 7701(a)(2)
 - “Syndicate, group, pool, joint venture, or other unincorporated organization through or by means which any business, financial organization or venture is carried on, and which is not within the meaning of the Code, a corporation, trust or estate.”
- Common law and state partnership statutes are not determinative
- Importance of intent
 - Profit motive
 - Business purpose
 - Partnership agreement and tax returns

General types of business entities

	C Corporation	S Corporation	Partnerships
WHO OWNS BUSINESS?	Shareholders	Qualified Shareholders	Partners
PERSONAL LIABILITY FOR BUSINESS DEBTS	No personal liability of shareholders	No personal liability of shareholders	Depends upon the type of partnership structure and partner
NUMBER OF OWNERS	Most states allow one-person corporations; some require two or more shareholders	Came as C corp, but no more than 100 shareholders permitted	Minimum of two owners to be treated as a partnership
WHO GENERALLY FINDS THIS THE BEST WAY TO DO BUSINESS?	Owners who want limited liability and ability to split income between themselves and a separately taxed business	Owners who wanted limited liability and individual tax rates to apply business income; must be willing to meet initial and ongoing S corp requirements	Owners who want limited liability and either pass-through or corporate taxation; particularly beneficial for smaller, privately held businesses
HOW BUSINESS PROFITS ARE TAXED	Split up and taxed at corporate rates and individual tax rates of shareholders	Individual tax rates of shareholders plus possible corporate-level taxes for former C corp	Individual tax rates of partners
DEDUCTIBILITY OF BUSINESS LOSSES	Corporation may deduct business losses up to the amount of income with carryovers (shareholders may not deduct losses)	Generally deductible when partners are "at-risk" and has sufficient tax basis	Generally deductible when partners are "at-risk" and has sufficient tax basis
TAX LEVEL WHEN BUSINESS IS SOLD	Two levels; shareholders and corporation may be taxed on liquidation if it includes sale or transfer of appreciated property	Normally taxed at personal tax levels of individual shareholders, but corporate level tax sometimes due if S corp was formerly a C corp	Personal tax level of individual partners

Partnerships: The entity of choice

- Overall flexibility
 - Economic arrangements
 - Allocations of profit and loss
 - Types and numbers of partners
- Single layer of tax
- Potentially a lower rate of tax on certain types of income
- Distributions of appreciated property do not generate an entity level tax burden
- Ability to deduct losses incurred by the partnership against income derived from other sources

Popular forms of partnerships

- General Partnership (GP)
- Limited Partnership (LP)
 - Only the General Partner(s) are jointly and severally liable for partnership debts
 - Limited Partners maintain limited liability
- Limited Liability Partnership (LLP)
 - Offers limited liability protection to all of its partners
 - Limited to use by specific service oriented professionals
- Limited Liability Company (LLC)
 - Most popular “partnership” entity
 - Offers limited liability protection to all of its members

Poll question

What tax return is a partnership required to file on an annual basis?

- Form 1120
- Form 1040
- Form 1065
- Form 1120-S

Understanding “The Deal”

- Understanding the business of the partnership
 - Common questions to ask
 - What types of assets will the partnership own?
 - Who is responsible for management and operations?
 - Legal entity status? GP, LP, LLC or LLP?
 - What is the capital structure? Any debt?
 - Where is the business located? States of operation?
- Understanding the economic arrangement
 - Common questions to ask
 - What assets will each partner contribute?
 - What are the expectations of each partner?
 - Who is in control?

Partnership operations

- Partnership Agreement (“PA”)
 - Dictates all aspects of partnership operations
 - Ensure PA reflects intended economic relationship among partners
 - Describes assets contributed and capital ownership
 - Describes income allocation and distribution between partners-substantial economic effect
 - Provides rules for maintaining partner capital accounts
- Income allocations and distributions
 - How earnings are split among partners
 - Preferred returns versus straight up allocations
 - Annual tax distributions to cover income allocated
 - Who gets partnership losses and when

Exit strategies

- How and when do I get my money out?
 - Redemption or liquidation of interest
 - Liquidation in accordance with adjusted capital account
 - Gain or loss on liquidation is generally capital
 - Gain may be deferred if assets other than cash or marketable securities are used to liquidate partner
 - Sale or exchange of partnership interest
 - Gain or loss is triggered and is generally capital in nature
 - PA may restrict sale to outside third parties
 - Gain or loss is calculated by comparing amount of cash received to partner's tax basis in partnership interest

Poll question

When presented with an opportunity to assist a client in structuring a partnership transaction what is the first thing a tax advisor should consider?

- The technical aspects of IRC Section 704(c)
- A detailed review of the partnership agreement
- Level of potential fees for future compliance services
- The economic arrangement between the partners and the business of the partnership

Hot industries

- Real Estate
 - Most popular entity for real estate transactions
 - Tax losses generated by depreciation deductions
 - Be careful - at risk rules and passive loss limitations
- Energy industry
 - Often structured as corporate joint venture
 - Very popular in alternative industry segments
 - Provides flexibility in structuring deals
 - Deferral opportunity for asset disposals

Hot industries (cont'd)

- Hedge funds
 - Lightly regulated investment partnerships with a limited number of accredited investors and high performance fees
 - \$1.4 trillion industry and growing!
- Private equity and venture capital funds
 - Partnerships that buy significant ownership stakes in private companies with the goal to restructure capital, management and organization for eventual resale
 - Structured to allow managing members and limited members to own pieces of the same entity with different economic arrangements

Poll question

What services do tax professionals generally provide to their clients who are considering either entering into an existing partnership or organizing their own partnership?

- Advice regarding the partnership agreement or membership agreement.
- Assistance with economic modeling and cash projections.
- Consultation regarding the annual tax implications of owning partnership units.
- Analysis of annual profit and loss allocations and potential exit strategies.
- All of the above

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