Operating Agreements for LLCs and Partnerships from a Tax Perspective

Presented by Olsen & Company CPAs

(Reid Olsen: Presenter)

November 18, 2015

Olsen & Company CPAs

132 SW 5th Ave #100

Meridian, ID 83642

208.888.1595

REID W. OLSEN
CERTIFIED PUBLIC ACCOUNTANT
OLSEN & COMPANY CPAS

FIRM DESCRIPTION

Olsen & Company, CPAs. PA. is a local accounting firm located in Meridian, Idaho since 1984. With 17 employees, we strive to serve the small business community and their owners. We offer a full range of accounting services, including bookkeeping, general ledger support, tax preparation, tax planning and small business organization and planning. The firm is based on the concept of being the financial and accounting arm of businesses and their owners. We service clients ranging from small home internet businesses to companies with sales approaching $25 million and anywhere in between.

WORK EXPERIENCE

1976-1977: Assistant Administrator, Cotter Health Centers, Inc., Sebastopol California
1977-1979: Staff Accountant, Simmons, Sieloff & Parkinson, CPAs, Boise, Idaho
1979-1981: Staff Accountant, O'Brien, Simmons & Co, CPAs, Boise, Idaho
1981-Present: President, Olsen & Company CPAs, Meridian Idaho

EDUCATION AND CERTIFICATES

High School Diploma Boise High School 1968
Bachelor of Science in Psychology from Brigham Young University 1974
Masters of Business Administration (MBA) from Brigham Young University 1976
Certified Public Accountant (CPA) 1978
Certified Management Accountant (CMA) 1983
Member AICPA and ISCPA

FAMILY

Married with five children and and nine grandchildren.

OTHER

Performed missionary services in Brazil from 1969 to 1971
Guest lecturer for Idaho State Association of Life Underwriters and the Idaho Real Estate School
Member of the Board of Trustees for Joint School District #2 (Meridian)
Past member of the Board for the Meridian Chamber of Commerce
Treasurer for the political campaigns of a former Attorney General and State Senator
Have held various positions with the Boy Scouts of America
Positions as corporate director, conservator and trustee with various organizations
Current member of the Eagle Chamber of Commerce

REFERENCES AVAILABLE UPON REQUEST

Information That Should Be Included In Every Partnership or LLC Agreement

A) Basic Information for All Agreements

1) Complete information concerning every partner (members in LLC's will be also called partners for purposes of these disclosures) including contact information and initial contributions to partnership at time of formation.

2) Details concerning which partners are able to contract for and/or incur debt on behalf of the partnership.

3) Disclosure of which partner will be the "Tax Matters Partner" for dealing with the Internal Revenue Service and handling all necessary correspondence dealing with tax matters.

4) The profit sharing percentages among the partners for allocating all recurring items of gain or income from partnership operations.

5) The loss sharing percentages among the partners for allocating all recurring items of loss or expense from partnership operations.

6) All items of gain, income, loss, expense or credit that will be specially allocated in a manner not in proportion to the ownership percentage determined by the partners' capital accounts.

B) Requirements For Special Allocations. In order to make any special allocations or distributions, the partnership agreement must contain the next five items which establish economic effect.

7) Upon formation (or as soon as reasonably possible) a second set of accounting books will be established based upon the fair market value of contributed and purchased assets and liabilities as outlined in IRS Code Section 704(b)

8) These books establish and ownership percentages of the partnership per the balances in the capital accounts and all transactions and events will flow through these capital accounts in order to demonstrate true economic effect.

9) Upon liquidation of the partnership at any time (or the liquidation of a partner's interest by the partnership) the value of the assets to be received by each partner will be determined by the balance in their respective capital accounts (as updated – see #26 below).

10) If any partner has a negative balance in his/her capital account at the time of liquidation, such partner will be required within 90 days to contribute cash or assets with a fair market value equal to the negative balance – in order to restore the negative capital account to zero.

11) If any partner does not want to be required to restore a negative capital account and will not accept the requirements of # 10 above, that partner will be allowed to receive special allocations and distributions up to the point that his/her capital account reaches zero. At that time, all allocations and distributions will be halted if they will cause the partner's capital account to go negative (all allocations of expense and losses as well as distributions will be made to the other partners and they will not be limited). If an allocation or distribution is accidentally made that causes such partner's capital account to go negative, a special "qualified income offset" will be made as soon as possible to that partner to return the capital account to a zero balance.

C) Handling Of Partnership Debts

12) Any debt assumed by the partnership through the contribution of an asset by one of the partners will become a legal debt of the partnership as outlined in IRS Code Section 752. This is true even when only the contributing partner has signed on as guarantor of the debt.

13) When the partnership assumes a debt on a contributed asset, the noncontributing partners agree to indemnify the contributing partner for their share of the debt should the contributor be required to made payment to the bank based upon his personal guaranty (based upon their capital account percentage of ownership at the time the payment to the bank is required to be made). This clause enables the debt to be considered a recourse debt for all partners for purposes of debt basis allocations (see #'s 15 and 16 below).

14) At the time a debt is assumed by the partnership through the contribution of an asset by a partner, such contributing partner will provide all pertinent and necessary information to the partnership concerning the debt. Such information will include when the debt was incurred, what the debt proceeds were used for by the contributor, as well as all payment terms and conditions. This information will aid the partnership in determining whether a disguised sale under IRS Code Section 707 is involved with the contribution and assumption.

15) All recourse debt outstanding at the end of the tax year will be allocated at that time based upon the complete liquidation principle where all assets are valued at zero and the corresponding loss is allocated to the partners' capital accounts in accordance with the loss provisions outlined earlier in the agreement. All partners will be allocated their portion of the recourse debt based upon the negative balance in their capital accounts and the requirement to restore such negative balance. This principle established who is really as risk for repayment of the recourse debt.

16) All nonrecourse debts will be allocated to all partners under a three-tier system (see # 20 below for further clarification of this procedure). The three tiers include: a) any remaining built in gain in the asset that secures the nonrecourse debt (if built in gain does exist) will require an

allocation of that much of the nonrecourse debt to the original contributing partner, b) all minimum gain inherent in the underlying asset will cause nonrecourse debt to be allocated in the same percentage that nonrecourse debt deductions were allocated to the partners (once again, see # 20 below), and c) the remaining nonrecourse debt will be allocated to the partners based upon their income and gain allocation percentages outlined earlier in the agreement.

D) Handling of Built In Gains.

17) All built-in gains will be tracked for seven years after contribution so that the amount of the original built-in gain can be allocated to the contributing partner should the asset by sold or distributed to another partner as required by IRS Code Section 704(c). Any appreciation or reduction in value after the date of the initial contribution is to be shared by all of the partners. These allocations of both pre-contribution gain as well as the post-contribution gain or loss shall follow the principles of the traditional method whenever possible. If that method does not provide economic effect, curative allocations shall be made whenever possible. If the curative allocations cannot be made, since the partnership does not have any similar items that can be allocated to have economic effect, then the remedial method will be used and an entry shall be made that will cause all parts of the transaction to have economic effect. In addition, if the asset is not sold or distributed at the end of the seven year period, all of the original built-in gain will at that time belong to the partnership and be allocated to all of the partners based upon their profit percentages.

18) If the contributed asset is depreciable, notwithstanding the previous discussion on how losses and expenses will be allocated, a special process will be made as required in the regulations to IRS Code Section 704(c). Depreciation will be allocated away from the contributing partner and to the other partners until such time as the other partners have the same amount of depreciation for tax purposes as they have allocated to their capital accounts for purposes of maintaining the Code Section 704(b) books. This shall first be done by applying the traditional method unless limited by the “ceiling rule” (insufficient tax depreciation to equal the 7004(b) depreciation). At that time, the curative method shall be used to allocate other depreciation on other assets until the required results are realized. If there is no other depreciation to be allocated, the remedial method will be used to made an entry in the books recognizing an equal amount of ordinary expense and ordinary income. The ordinary expense will be allocated to the noncontributing partners and the ordinary income will be allocated to the contributing partner. The net effect of these special allocations is to reduce the built in gain each year over the useful life of the asset until the built-in game is finally eliminated unless the asset is prematurely sold or distributed.

19) If a contributing partner were to leave the partnership by receiving assets other than the original contributed property with the built-in gain, the principles of IRS Code Section 737 shall

be applied and the contributing partner will be required to recognize all of the remaining built-in gain prior to leaving the partnership with a corresponding increase in the basis of the asset on the books of the partnership.

E) Nonrecourse Deduction, Minimum Gain and Minimum gain Chargeback. These are special requirements of the regulations dealing with nonrecourse debt on depreciable assets where special allocations of depreciation expense can be made as well as special allocations of nonrecourse debt for purposes of determining debt basis for taking partnership losses.

20) Nonrecourse deductions are depreciation expenses on an asset once the balance of the nonrecourse debt exceeds the remaining basis in the asset (at this point, the partnership no longer has any equity in the asset since the amount of the debt exceeds the basis) These nonrecourse deductions can be allocated in any manner outlined in the partnership agreement, and since their allocation will cause a greater amount of nonrecourse debt to be allocated to those partners receiving the greater amount of nonrecourse deductions, this is one area where additional nonrecourse debt basis can be assigned a particular partner by simply allocating more of the nonrecourse deductions to him/her.

21) The reason that nonrecourse deductions can be allocated to the partners at all (since they are not at risk on the asset and the depreciation would really appear to be the deduction of the bank since they are the one at risk) is based upon the principal of minimum gain. When the amount of the debt exceeds the basis of the asset, there will always be a gain should the bank foreclose on the asset (the outstanding debt will be the sales price with the remaining basis being subtracted to calculate the "minimum gain"). Since this gain is always present and increases in size with each year's depreciation (provided the debt is not reduced or repaid), the nonrecourse deductions become deductible with economic effect. The underlying minimum gain is allocated to the partners in the same manner as the nonrecourse deductions (this allocation of minimum gain is not a taxable event, but is merely tracked to determine who has the potential for minimum gain should the bank ever foreclose. In addition, the amount of the minimum gain allocated to each partner is one of the tiers for allocated nonrecourse debt as explained in #16 above).

22) Minimum gain chargeback is an item that both affects the taxable income allocations and is also tracked in order to allocate nonrecourse debt. Should the nonrecourse debt ever be paid down (or off completely) in any year in excess of the amount of that year's nonrecourse deduction (depreciation on the underlying asset), the minimum gain will actually be reduced at year's end. This reduction in minimum gain must be allocated back to the partners in the same percentages as the original minimum gain was allocated in order to arrive at the new minimum gain numbers for allocating the second tier of the nonrecourse debt computation.

Example: In order to better demonstrate how the items of this section are treated, maybe an example would be appropriate. Assume that ABC partnership has three members and profits are allocated equally between then while losses go 60% to A and 20% to both B and C. Normal depreciation expenses are allocated equally in determining the net income for the period except there is a provision that nonrecourse deductions will be allocated 60% to A and 20% to both B and C (this is being done since A is in need of the extra nonrecourse debt allocation for basis determination – since he is taking a higher loss percentage). The partnership purchases a piece of five year equipment during 2012 at a cost of $200,000 by paying $30,000 cash and obtaining a $170,000 nonrecourse loan from the seller. (For simplicity purposes, let's assume that the loan requires interest only and isn't due for five years. In addition, depreciation will be calculated straight line). For 2012, depreciation on the equipment is $20,000 (half year convention) and is allocated equally in order to determine net income or net loss. During 2013, the depreciation would be $40,000 and $10,000 is normal depreciation and $30,000 is nonrecourse deduction depreciation. (Once the remaining basis is equal to the outstanding loan amount, the normal depreciation stops, and any additional depreciation is nonrecourse deduction depreciation). At the end of 2013 the remaining basis is $140,000 while the outstanding balance of the nonrecourse loan is $170,000 – thus, there is $30,000 of nonrecourse deductions that are allocated $18,000 to A and $6,000 each to B and C. There is also a minimum gain of $30,000 (since it equals the amount of nonrecourse deductions taken in total) which in a deemed foreclosure is the excess of the sales price (the amount of the loan) over the remaining basis. The minimum gain is allocated $18,000 to A and $6,000 each to B and C. During 2014, depreciation of $40,000 is taken again, but the partnership had some extra money and decided to pay down their nonrecourse loan by $50,000. At the end of 2014 the basis of the asset is $100,000 and the outstanding nonrecourse loan is paid down to $120,000 so there is still minimum gain of $20,000, but that amount is less than the year before. Therefore, none of the 2014 depreciation is nonrecourse depreciation and it will be allocated equally in determining net income or net loss for the year. In addition, the minimum gain was reduced from $30,000 to $20,000, therefore there must be a minimum gain chargeback of $10,000. Of this amount, A will be allocated a priority allocation of net income of $6,000 for 2014 and B and C will be allocated a priority allocation of $2,000 each. After these special allocations are made, the remaining net income (or larger loss by the $10,000 allocated in priority) will be allocated to the partners in accordance with the normal percentages contained in the agreement. Now, for allocating the nonrecourse debt at year end for the three years, let's start with 2012. In this year, there is no minimum gain nor built in gain (since the property was purchased by the partnership and not contributed by one of the partners). Therefore, there are no tier 1 or tier 2 allocations, and all of the nonrecourse debt is allocated based upon the partners' profit sharing percentages (all get an equal 1/3 allocation of the nonrecourse debt for debt basis purposes). During 2013 there is now minimum gain of $30,000 and this is

allocated to the partners based on how the nonrecourse deductions were allocated. So, it would look like this:

	A	B	C
Allocation based on minimum gain	$ 18,000	$ 6,000	$ 6,000
Balance allocated by profit %	46,667	46,666	46,666
Total nonrecourse debt allocation	$ 64,667	$ 52,666	$ 52,666

Now, in 2014 the debt has to be allocated gain based upon the ever-changing minimum gain (because of potential new nonrecourse deductions and in this case a minimum gain chargeback):

	A	B	C
Allocation based on minimum gain	$ 12,000	$ 4,000	$ 4,000
Balance allocated by profit %	33,334	33,333	33,333
Total nonrecourse debt allocation	$ 45,334	$ 37,333	$ 37,333

Hopefully, this example will demonstrate the complexities in dealing with nonrecourse debt allocations and the need to keep track of nonrecourse deductions (depreciation when debt exceeds remaining basis) the minimum gain allocations and the potential for minimum gain chargeback. It also shows that the debt basis can change dramatically each year and can only be calculated by the partnership return preparer who has the required information – so you can justify the fees that are charged to keep track of this stuff.

F) Retirement of a Partner From a Personal Service Partnership

23) When a partner is retiring from a personal service partnership, IRS Code Section 736 comes into play and overrides any other potential result from other code sections. The partner will receive 736(b) payments for the balance of the amount in his/her capital account (704(b) books) as well as additional payments under 736(a). These additional payments will be for the retiring partner's share of outstanding accounts receivable as well as any other amounts. If these additional amounts in excess of accounts receivable are for goodwill (as allowed for in the partnership agreement) then this will be treated as additional 736(b) payments for capital and the retiring partner will increase his capital gain from the liquidation of his interest – with a recognition of goodwill on the partnership books which will be amortized over 180 months. If the partnership agreement is silent concerning goodwill, the additional payments above the amount for accounts receivable will be considered to be a guaranteed payment with the partner recognizing ordinary income and the partnership receiving a guaranteed payment deduction.

24) If the retiring partner is to be paid off on the installment basis, the agreement should provide that all 736(b) payments for the partner's capital are to be made first and then the 736(a) payments. If done in this manner, the partner will be eliminated from being a partner (since his capital account will be zero) before he receives the 736(a) payments. While the accounts receivable payments and the possible guaranteed payments will still be ordinary income to the retiring partner upon receipt, he will not be subject to self-employment taxes and will not receive a K-1 from the partnership (rather his payments will come via 1099-ordinary income).

G) <u>Miscellaneous Items</u>

25) Special adjustments to the partnership tax books are allowed under IRS Code Section 754 upon the occurrence of seven different types of transactions. Five of these transactions will result in a step-up in basis of partnership assets, while two will result in a step-down of partnership assets. The partnership agreement should address these issues and either contain a clause that the 754 election will be made upon the first occurrence of one of these transactions, or that a majority vote of the partners will cause that the election will be made (it is my opinion that this election should be made since it generally results in a benefit to the partners).

26) Upon the occurrence of four different types of transactions (a new partner admitted through either a contribution of purchasing another partner's interest, a retirement or liquidation of a partner's interest, a new contribution made by an existing partner, or distributions in excess of current years' net income) the partnership is allowed per regulation 1.704-1(b)(2)(iv) to adjust the 704(b) books to update them to the current fair market value. This is necessary in order to determine the correct amount that should be paid for a partnership interest, the amount to be paid upon liquidation or to determine the proper ownership percentages upon the occurrence of any of the transactions listed above.

27) Cancellation of Debt income in a partnership is determined at the partnership level, but his then allocated to the partners on their K-1's. Since cancellation of debt income increases the basis of the partners, care must be taken to insure that the cancellation of debt income is allocated to the partners in the same percentages that the underlying forgiven debt was allocated at the end of the previous year. Since the cancellation of the debt also reduces debt basis for the partners (as well as the ordinary income that is true taxable income), if the cancelled debt income is not allocated properly, there could be a double problem for some of the partners who were relying on the debt basis to take previous losses.

28) When a partner is allocated cancellation of debt income and his outside basis as well as his inside basis is increased, the partner still has the opportunity to find an exception under IRS

Code Section 108 where that income will not have to be recognized for tax purposes. If a partner does avail himself of one of the exceptions, he must reduce his outside basis by the amount of the cancellation of debt income not recognized and must contact the tax matters partner or the preparer of the partnership return to disclose that he excluded some of the income. On the partnership books, that partner's inside basis must be reduced and his inside basis in the partnership assets will also be reduced. This will result in a reduced depreciable basis of some of the assets just for allocation purposes to that partner.

29) When a partner sells an interest in the partnership to an outsider (someone who is not a current partner in the partnership) he shall within 30 days provide in writing to the partnership the details of his sale including the total sales price and any special terms that would be of interest to the partnership. This is necessary since the partnership will be required to file Form 8308 *Report of a Sale or Exchange of Certain Partnership Interests* with its tax return.

30) The agreement should have wording to the effect that upon a partner's desire to sell his interest, the partnership or other partners shall be given the first right of refusal to purchase the interest of the partner who is leaving. If they do not choose to exercise this right, they should still be given the opportunity to accept by vote the new partner assuming that they have the majority percentage of vote.

31) Should the sale of all of more than 50% of the partnership interests occur, the termination of the partnership will occur and the remaining partners (including the new purchaser if applicable) will have the right to continue the partnership as a new partnership with the existing TIN but with all new elections of accounting methods available.

32) A new ruling now allows a partner or LLC member to pay indirect partnership expenses and not be reimbursed but still get to deduct them on schedule E as a reduction of the pass through income from the partnership or LLC. There must be a written agreement that states that the partners (members) will not reimbursed for their indirect costs that they pay (travel, meals, entertainment, etc). There is not a better place to put such written agreement than in the body of the operating agreement.

Personal Services Provided

- Tax Return Preparation
- Transactional Tax Planning
- IRS and State Audit Assistance
- Estate Planning and Retirement Services

Business Services Provided

- Tax Return Preparation
- Bookkeeping
- Payroll
- QuickBooks Assistance
- Financial Management Reporting
- Compiled and Reviewed Financial Statements
- Tax Planning
- Budgeting and 5 year Planning
- Balance Sheet Analysis
- Succession Planning
- Multigenerational Business Planning
- IRS and State Audit Resolution
- Assistance with Bank Financing
- Business Turn Around
- Estate Planning
- Business Life Cycle Planning

Olsen & Company CPAs

132 SW 5th Ave #100

Meridian, ID 83642

208.888.1595