

# WADE ASH

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## **FAMILY PARTNERSHIP OR LIMITED LIABILITY COMPANY CHECKLIST**

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**CAUTION:** This summary is general information only. It is not legal advice.  
If you have questions about your specific situation, please contact us.

A family partnership or limited liability company (LLC) can be an important and useful vehicle for conducting a family business or managing family assets. Often, parents create a family partnership or LLC and then give partnership or LLC membership interests to their children or other descendants, or to trusts for them. The value of the partnership or LLC membership interests is often discounted substantially, so that interests can be given away at discounted values, and interests retained by the parents can be discounted, saving both gift and estate taxes.

To obtain the benefits of a partnership or LLC, it is essential that the partnership or LLC be created, maintained and operated properly. A partnership or LLC is a business, and it must be managed as a business. Several recent cases decided by the United States Tax Court demonstrate that if the partners do not follow the appropriate procedures, the parent may be considered to have retained the possession or enjoyment of the partnership's or LLC's property, or the income from the

property, with the result that all of the partnership assets will be taxed in the parent's estate. The parent's retained possession, enjoyment or income need not be pursuant to a legally binding agreement. The IRS can win this argument if there was an understanding that the parent retained possession or enjoyment of partnership property, or the income from the property, even if the understanding was only implied and not expressly stated.

Here is a checklist of basic steps to follow in forming and operating a family partnership or LLC to help ensure that the partnership or LLC will be respected for tax purposes.

- Forming the partnership or LLC.
  - Check the availability of the name, sign the Partnership Agreement or Operating Agreement creating the company, and file the appropriate documents with the Colorado Secretary of State.
  - Obtain a taxpayer identification number for the partnership or LLC. The Partnership or LLC will be a separate taxable entity for federal tax purposes and must have its own separate taxpayer identification number. We can obtain the number for you, or your accountant can obtain the number.
  - Open a bank account in the name of the partnership or LLC, using the partnership's or LLC's taxpayer identification number.
  - Promptly after the partnership or LLC is formed, make sure that each partner or member makes his or her initial capital contribution.
    - Cash contributions should be deposited in the partnership's or LLC's bank account.
    - Other contributions should be conveyed into the name of the partnership or LLC. For example, if real estate is contributed, the contributing partner or member should sign and record a deed to convey the property to the partnership or LLC.
    - Do not delay in making these contributions. Delay can give the IRS an argument that the contributing partner or member retained the use of the partnership's or LLC's property.
  - If real estate that is to be contributed to the partnership or LLC is encumbered by a mortgage or deed of trust, check the terms of the mortgage or deed of trust and, if necessary, communicate with the lender before transferring the property to the partnership or LLC. The mortgage or deed of trust will likely include a "due-on-transfer" provision that will allow the lender to call the loan if the property is transferred and a waiver is not obtained.

- ❑ If real estate is contributed to the partnership or LLC, obtain an endorsement to the title insurance policy to add the partnership or LLC as an insured party.
- ❑ Obtain appropriate property and casualty insurance in the name of the partnership or LLC.
- ❑ Keep the originals of important documents relating to the partnership or LLC (the certificate of limited partnership or articles of organization, and the partnership agreement or operating agreement) in a safe place. Each partner or member should be provided with a copy of these documents.
  
- ❑ Operating the partnership or LLC
  - ❑ When an important business decision is to be made, have a meeting of the persons entitled to vote on that matter (for example, the general partners or managers), and record the decision in minutes of the meeting.
  - ❑ All documents relating to the partnership's or LLC's business affairs should be signed in the name of the partnership or LLC by the appropriate party or parties—the general partners in the case of a partnership or the managers in the case of an LLC.
  - ❑ Keep appropriate books and records of the partnership's or LLC's assets, business activities, and income and expenses.
  - ❑ Have the partnership's or LLC's accountant prepare partnership income tax returns (IRS Form 1065) for the partnership or LLC, and make sure that the returns are filed on time. Make sure that each partner or member receives an appropriate IRS Form K-1, showing his or her share of the partnership's or LLC's income, deductions and credits, so that those items will be reported properly by the partners or members on their personal income tax returns.
  - ❑ Distributions from the partnership or LLC must be made in accordance with the terms of the partnership agreement or operating agreement. Generally, the agreement will require that distributions be made to all of the partners or members on a pro rata basis in accordance with their percentage interests. Disproportionate distributions to the parent(s) can be used by the IRS to show an agreement that the parent retained the use of the partnership property. If allowed under the terms of the partnership agreement or operating agreement, the partnership or LLC may make a *loan* to one or more partners or members, but the loan must be properly documented by signing a written promissory note, the note must include commercially reasonable terms as to the interest rate, time for repayment and security, and the note must in fact be repaid according to its terms.

- Do not assume that a distribution will not result in income tax. As a general rule, the partners in a partnership (including an LLC that is taxed as a partnership) are taxed on their shares of partnership income and gain regardless of whether distributions are made. As a corollary, there is a general rule that distributions do not *per se* result in taxable income. But there are important exceptions, and income may result from a distribution in several circumstances. For example, a distribution of money to a partner is taxable to the partner receiving the distribution to the extent that the money exceeds the partner's income tax basis in his or her partnership interest. For this purpose, the term "money" generally includes marketable securities. In addition, if a partner contributes property that has "built-in gain" (that is, the value of the property at the time of the contribution is more than the contributing partner's basis in the property), and if that property is distributed to another partner within seven years after the contribution, then the contributing partner is taxed on the built-in gain at the time of the distribution. Check with your accountant about the income tax consequences before making distributions.
- A partner or member who renders valuable services to the partnership or LLC, such as management of real estate, may receive reasonable compensation for his or her services. However, self-employment taxes must be paid on any compensation received.
- Do not allow any partner, member or manager to use any property that belongs to the partnership or LLC for his or her personal benefit.
  - The partnership's or LLC's bank account belongs to the partnership or LLC and should be used only to pay partnership or LLC related items.
  - If a partner, member or manager uses any real estate owned by the partnership or LLC, he or she should pay fair market rent. (In general, it is best not to have the partnership or LLC own personal use assets, such as a residence, to avoid this issue entirely.)
- Notify us or your accountant before you make any additional contributions to the partnership or LLC so that we may document the contribution and adjust the ownership interests.
- File the required periodic reports for the partnership or LLC with the Colorado Secretary of State.
- If there is a change in the registered agent or registered office, file a Change of Registered Office or Registered Agent or Both (Colorado Secretary of State Form 003) with the Colorado Secretary of State.

- ❑ Gifts of interests in the partnership or LLC
  - ❑ If you are going to make gifts of interests in the partnership or LLC, it is preferable to allow some time to go by after the partnership or LLC is formed before you make the gifts.
  - ❑ Obtain appropriate appraisals when making gifts of partnership or membership interests. To adequately document the fair market value of the partnership or membership interests you plan to give away, you may need two appraisals. First, if the partnership or LLC owns assets that are not easily valued, such as real estate, you will need to obtain a valuation of those assets—for example, an appraisal from a qualified real estate appraiser. Second, you will need to obtain an appraisal of the partnership or LLC interests that will be given away. This appraisal should be prepared by a qualified business appraiser, who will review the partnership or operating agreement, and the rights of the partners or members, as well as the assets owned by the partnership or LLC and its business activities, to determine the value of the interests you plan to give away. A new or updated appraisal should be obtained each time a gift is made.
  - ❑ Gifts of partnership or membership interests should be documented by a written assignment, which should be signed both by the person making the gift and by the person receiving the gift.
  - ❑ File gift tax returns (IRS Form 709) when appropriate. While no gift tax return will be required if all gifts are within the available gift tax annual exclusions (\$13,000 per donee, per year, in 2009 and 2010), we strongly recommend that you file annual gift tax returns to start the statute of limitations running for the valuation of gifts. If the gifts are made in trust, other considerations (such as allocation of generation-skipping transfer tax exemption) may also require filing a gift tax return.



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