

CHERRY CREEK CORPORATE CENTER
4500 CHERRY CREEK DRIVE SOUTH #600
DENVER, CO 80246-1500
303.322.8943
WWW.WADEASH.COM

DISCLAIMER

Material presented on the Wade Ash Woods Hill & Farley, P.C., website is intended for informational purposes only. It is not intended as professional service advice and should not be construed as such.

The following memorandum is representative of the types of information we provide to clients when we prepare estate planning documents for them. However, this material may not be used by every attorney in the firm in every case. The attorneys at Wade Ash view each case as uniquely different and, therefore, the information we provide to our clients may be substantially different depending on the client's needs and the nature and extent of their assets.

Any unauthorized use of material contained herein is at the user's own risk. Transmission of the information and material herein is not intended to create, and receipt does not constitute, an agreement to create an attorney-client relationship with Wade Ash Woods Hill & Farley, P.C., or any member thereof.

FAMILY PARTNERSHIP OR LIMITED LIABILITY COMPANY CHECKLIST

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 as part of 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.

WADE ASH WOODS HILL & FARLEY, P.C.

Following is a checklist of basic steps to follow in forming and operating a family partnership or LLC to help insure 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 to officially form the partnership or LLC.
 - Obtain a taxpayer identification number for the partnership or LLC from the IRS. 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 (such as the certificate of limited partnership or articles of organization, the partnership agreement or

WADE ASH WOODS HILL & FARLEY, P.C.

operating agreement, and meeting minutes) together 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 or members 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. If the LLC is wholly owned by one member, a separate income tax return need not be filed. Such an LLC is treated as a “disregarded entity” and all items of income and deduction are reported on the owner's personal 1040.
 - ❑ 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

WADE ASH WOODS HILL & FARLEY, P.C.

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. If the "built-in gain" rule does not apply, then usually a distribution of real property will not cause a taxable event to the partner; instead, the partner will receive a carryover basis in the property. 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 (reports are generally required annually).
- If there is a change in the registered agent or registered office, file a Change of Registered Office or Registered Agent or Both with the Colorado Secretary of State. This can be done on-line at www.sos.state.co.us.
- 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

WADE ASH WOODS HILL & FARLEY, P.C.

easily valued, such as real estate, you will need to obtain a valuation of those assets—for example, an appraisal from 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 (currently \$14,000 per donee, per year, in 2015 and 2016), 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. If any discounts in valuation are taken to determine the value of the gifts, be sure to check the appropriate box, and make *full disclosure* on the gift tax return.