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ALERT: Partnerships and LLCs' complex tax environment requires careful planning to avoid unanticipated taxes

More and more businesses are taking advantage of the flexibility available by structuring their companies as partnerships or LLCs instead of corporations. However, the downside of these entity types is the highly complex tax considerations that may be triggered with ownership-change transactions. **Often what appears to be a straightforward purchase, sale, buyout or other transaction with clear tax ramifications requires a significant amount of planning to avoid unintended tax and other consequences.**

Partnership and LLC taxes are significantly more complex than C or S corporation tax filings; **we cannot stress enough how important it is to keep your tax professional informed of your business activities, even if you don't think tax issues are involved.** Keeping communications open helps us help you avoid penalties, increases in tax liability and other undesired consequences. Following are some examples of the complexities that we have seen arise for partnerships and LLCs:

- Sale of partnership interest may result in substantial tax liability on what is recognized as ordinary income, while the partner may have anticipated using the capital gains tax rate.
- Another fairly common issue we have seen recently is partnership or LLC owners being treated as employees of the partnership or LLC. The IRC does not allow partners or LLC shareholders to be treated as employees, and owners can be subject to tax penalties.
- Conflicts of interest can arise when ownership transactions in partnerships or LLCs occur, with a tension caused by balancing the needs of a partner perhaps leaving the business with the needs of the business and the remaining partners. Depending on how a transaction is handled, the difference in tax effects for both the partner(s) and the partnership could be substantial – the difference between ordinary and capital gains taxes and between an ordinary deduction or no deduction.
- A number of situations related to ownership transactions for partnerships and LLCs require significant tax planning beforehand. In particular, when 50% or more of the total interests in a partnership are sold or exchanged in a 12-month period, or when installment sales of partnership interests between related parties are involved, it is important to consult your tax professional before completing the transaction to examine the potential tax effects.
- If a partner contributed property to a partnership, then receives cash or other property from the partnership, the transaction may qualify as a “disguised sale of assets” and create a tax liability from what otherwise would be a nontaxable distribution from the partnership.
- When a new partnership is formed to bring in new private equity, business owners who contributed to the new partnership and also received some cash distribution from the new equity owners should consult with a tax professional. The costs involved with setting up the transaction may be treated in several different ways for tax purposes – ranging from deductible ordinary expenses to nondeductible/nonamortizable capitalized syndication costs – so it's essential to understand how these expenses will affect taxable income.

As always, if you have any questions about this alert or would like to consult with your AGH tax advisor on any of these issues, please contact us at (316) 267-7231.

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