NINJA BOOK

Regulation

Partnership Taxation

Partnership Taxation

Overview

Generally, partnerships are not tax-paying entities. Rather, they are conduits through which several types of income, loss, deductions, and credits are passed to the part through which several types of income, loss, deductions, and credits are passed to the partners [IRC §701].

- **Entity Classification** Under the *check-the-box* regulations, an eligible entity is an entity that does not meet the definition of a corporation under the regulations and is not a single owner entity, trust, or otherwise subject to special treatment under the IRC. If the entity fails to elect a classification, the regulations provide a default classification.
  - ✔ A partnership is a syndicate, group, pool, joint venture, or other unincorporated entity through which a business is carried on, and which is not a corporation, trust, or estate.
  - ✔ Mere co-ownership of property is not a partnership. However, if the entity provides services in conjunction with the use of the property by the lessee or licensee, the entity may be characterized as a partnership.
  - ✔ Limited partnerships are subject to the same rules as general partnerships.
  - ✔ Limited liability entities may be classified for federal tax purposes as either corporations or partnerships. Limited liability companies (LLC), limited liability partnerships (LLP), professional limited liability companies, etc., are frequently designed to take advantage of the pass-through tax status of partnerships or corporations, but the partnership tax status is not automatic. A limited liability entity must meet specific conditions that require it to be taxed as a corporation or elect to be treated as such. If conditions are not met and no election has been made, then it is treated as a partnership for tax purposes.
- **Information Return** Partnerships must file an information tax return (Form 1065) showing partnership income. Failure to file a return can result in a penalty being assessed against the partnership. The penalty amount is based on the number of partners. In general, partnerships with more than 100 partners must provide Form 1065 and copies of each partner's Schedule K-1 to the IRS on magnetic media. Since the items will be reported on the tax returns of the partners, the partners must segregate items that have special treatment on their individual tax returns. The partnership prepares a **Schedule K** that summarizes ordinary income and separately lists all items that are not ordinary. Additionally, a **Schedule K-1** is prepared for each partner showing that partner's allocated share of all the items on the Schedule K
- **Tax Year** The partnership's taxable year majority interest in the partnership, unless a business purpose can be established for designating a different taxable year [IRC §706(b)(1)]. The taxable year of a partnership generally is not affected by the entry of new partner. The taxable year of a partnership generally is not affected by the entry of new partners or the death or retirement of old partners.
  - ✔ **Principal Partners** If partners owning a majority interest do not have the same taxable year, the partnership must adopt the taxable year of its principal partners. Principal partners are partners having an interest of 5% or more in the partnership's profits or capital.
  - ✔ **Calendar Year** If neither partner owning a majority interest nor principal partners have the same taxable year, the partnership must adopt a calendar year as its taxable year.

- ✔ **Fiscal Year** A partnership can elect to use a fiscal year instead of a calendar year as long as the fiscal year does not result in a deferral period that is greater than 3 months [IRC §444]. Therefore, a partnership that normally is required to have a calendar year under IRC §706 can elect to have a fiscal year if the fiscal year ends on September 30, October 31, or November 30. For more information, see the coverage of S corporations.

- ✔ **Termination** The taxable year closes upon termination of the partnership.

- ✔ **With Respect to One Partner** The taxable year of a partnership closes *with respect to a partner* whose entire interest in the partnership terminates, whether by death, liquidation, sale, exchange, or otherwise. The taxable year of a partnership does not close with respect to a partner who disposes of less than her/his entire interest in the partnership, but that partner's distributive share must reflect her/his varying interests during the year.

- **Partner Level** Each partner reports her/his distributive share of income, loss, deduction, and credit for the partnership's taxable year that ends within or with the partner's taxable year [IRC §706(a)].

Example - 1 Timing of Income Recognition

A. Both the partnership's and the individual partners' taxable years end on December 31, Year 5. The partners report their shares of Year 5 partnership income, etc., on their Year 5 returns.

B. An individual partner is on a calendar-year basis, while the partnership is on a fiscal-year basis ending January 31. The partner's share of partnership income, etc., for the partnership year ending January 31, Year 5, is reported on her/his Year 5 return, (e.g., the return filed in Year 6.)

Overview of Form 1065

Each partner must account for her/his share of partnership items. The partner is taxed on the distributive share. The actual distributions are rarely taxable events, but merely a return of previous investment or previously taxed partnership income.

- **Types of Income**

  - ✔ **Ordinary Business Income**

Business Net Receipts
<Deductions>
Ordinary Business Income

  - ✔ **Separately Stated Item**

Any item which is always included in gross income of an individual without any limitations or restrictions need not be separately stated. The purpose of separately stating items is to allow any special treatment on individual returns. Following are examples of separately stated items:

Separately stated item	Reason not included in ordinary income
Interest & Dividends	Needed for investment interest limitation
Capital gains and losses	Limit on deductibility of net capital losses
Passive activities	Passive activity loss limitations
Section 1231 gains and losses	Classification of net gain as capital gain
Section 179 election	Dollar limit on use of election per year
Charitable contributions	Must itemize to deduct Up to 50% of AGI
Tax credits	Limited to tax liability

✔ **Guaranteed Payments to Partners**

Guaranteed Payments to partners such as salary, fringe benefits, interest on capital which are to be paid regardless of partnership profit or loss. Such payments are first deducted in Form 1065 to arrive at Ordinary Business Income from Partnership and then added to Schedule K which then flows from Schedule K to partner's individual Schedule K-1 and further to Form 1040.

✔ **Flow of Form 1065 to Form 1040**

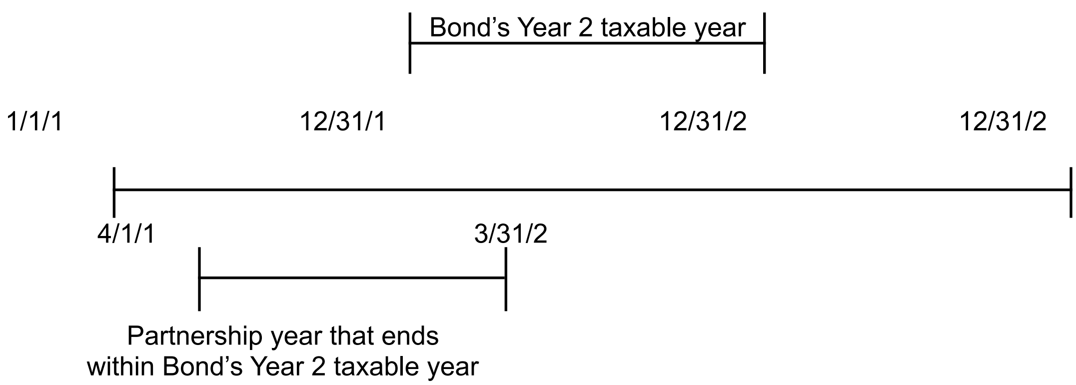
Form 1065	Total Business Income <Business Deductions> **<Guaranteed Payment>**
Schedule K	**Ordinary Business Income** Interest & Dividend Income Guaranteed Payment Rent & Royalties Capital Gains & Losses Unrecaptured Sec. 1250 Gain Sec. 1231 Gain or Loss <Sec. 179 Deduction> <Charitable Contributions> <Investment Interest Exp.> <Tax Credits> **Reconciled Income or Loss**

Schedule K-1	Form 1040
% Ordinary Business Income	Schedule **E**
Guaranteed Payment	Schedule **E**
% Interest & Dividend Income	Schedule **B**
% Rent & Royalties	Schedule **E**
% Capital Gains & Losses	Schedule **D**
% Unrecaptured Sec. 1250 Gain	Schedule **D**
% Sec. 1231 Gain or Loss	Schedule **D**
<% Sec. 179 Deduction>	Schedule **E**
<% Charitable Contributions>	Schedule **A**
<% Investment Interest Exp.>	Schedule **A**
<% Tax Credits>	Form **1040**
% Reconciled Income or Loss	

Example - 2 Income Recognition

The partnership of Bond and Felton has a fiscal year ending March 31. John Bond files his tax return on a calendar-year basis. The partnership paid Bond what the partnership calls a guaranteed salary of $1,000 per month during calendar Year 1 and $1,500 per month during calendar Year 2. (The IRC calls this a guaranteed payment.) After deducting this salary, the partnership realized ordinary income of $80,000 for the year ended March 31, Year 2, and $90,000 for the year ended March 31, Year 3. Bond's share of the profits is the salary paid him plus 40% of the ordinary income after deducting this salary. For Year 2, Bond should report taxable income from the partnership of $45,500.

Computations:



Bond includes in his personal gross income only his pro rata share of partnership income (distributed or undistributed) for his taxable year ending with or within the taxable year of the partnership. Bond's Year 2 taxable year ends on December 31, Year 2. However, the partnership's taxable year begins on April 1, Year 1, and ends on March 31, Year 2. Therefore, Bond's share of partnership income for calendar Year 2 is:

$1,000/month × 9 months of Year 1	$ 9,000	
$1,500/month × 3 months of Year 2	4,500	
Salary received from April 1, Year 1, to March 31, Year 2		$ 13,500
Add Bond's share of partnership income realized during April 1, Year 1 to March 31, Year 2 (80,000 × 40%)		32,000
Bond's Year 2 taxable income from the partnership		$ 45,500

The $13,500 salary that Bond received during the last nine months of Year 2 must be considered in determining his taxable income from the partnership for Year 3. The same applies to his pro rata share of the $90,000 partnership income realized during the partnership's fiscal year, beginning on April 1, Year 2, and ending on March 31, Year 3. This is because it relates to the partnership year that ends with or within Bond's Year 3 taxable year.

Example - 3 Income Flow-Through from Partnership

	XY Partnership Items	Trial Balance	Partnership	Partners
(A)	Sales	$100,000	$ 100,000	
(B)	Cost of goods sold	(50,000)	(50,000)	
(C)	Salaries	(20,000)	(20,000)	
(D)	Other operating expenses	(10,000)	(10,000)	
(E)	Guaranteed payments	(5,000)	(5,000)	
(F)	Dividends	1,000		$ 1,000
(G)	Short-term capital gains	2,000		2,000
(H)	Short-term capital losses	(4,000)		(4,000)
(I)	Long-term capital gains	10,000		10,000
(J)	Section 1231 casualty loss	(3,000)		(3,000)
(K)	Section 1231 gain	5,000		5,000
(L)	Charitable contributions	(1,000)		(1,000)
(M)	Section 1245 gain	3,000	3,000	
Net income from operations (A, B, C, D, E and M)			$ 18,000	

(1) Items F through L pass through the partnership's return and are not considered in arriving at the partnership's net income from operations. These items are treated individually by the two partners, X and Y, based on special allocations (if having substantial economic effect) or profit-and-loss sharing ratios, and are dealt with in the tax returns of the individual partners.

Note that items F through L are items of income and expense that are generally subject to individual taxpayer limitations. Such limitations apply to each individual partner of the partnership. For example, item F, Dividends, is not considered at the partnership level but is passed through and dealt with on the returns of the partners. Thus, in the case of a corporate partner, the dividends are eligible for the 80% deduction of IRC §243.

(2) The partnership's net income from operations, $18,000, is computed on the basis of items A, B, C, D, E, and M. This net taxable income is divided among the partners according to their profit-and-loss sharing ratios.

Application - 1

PDK, LLC had three members with equal ownership percentages. PDK elected to be treated as a partnership. For the tax year ending December 31, year 1, PDK had the following income and expense items:

Revenues	$120,000
Interest income	6,000
Gain on sale of securities	8,000
Salaries	36,000
Guaranteed payments	10,000
Rent expense	21,000
Depreciation expense	18,000
Charitable contributions	3,000

What would PDK report as non-separately stated income for year 1 tax purposes?

a. $30,000
b. $35,000
c. $43,000
d. $51,000

(b) While each partner calculates an individual §179 deduction, regular depreciation is deducted in arriving at the partnership's non-separately stated income. Salaries, guaranteed payments, and rent expense also are deducted in arriving at the partnership's non-separately stated income. Charitable contributions, gain or loss on the sale of securities, and portfolio income and expense items (dividends, interest, and royalties) are reported separately on the partnership return. $120k − $36k − $10k − $21k − $18k = $35k)

Partnership Formation and Operation

Contributions by the Partner to Partnership

No gain or loss is recognized by the partnership or any partner when property is contributed to the partnership in exchange for an interest in the partnership [IRC §721(a)]. Note also that, unlike IRC §351 transfers to a corporation, there is no control requirement on transfers to a partnership.

- **Cash:** When a partner contributes cash, their basis is increased by the amount paid.
- **Services:** When a partner renders services to the partnership in exchange for an interest in the business, the partner reports ordinary income equal to the FMV of the partnership interest being granted, and the partner's basis is increased by the same amount.
- **Property:** When a partner contributes property, their basis is increased by the partner's tax basis in the contributed asset and the Fair Market Value is ignored. However, if the asset being contributed is subject to a liability, the partner's net contribution is reduced because of the contributed liability, but then each partner's basis is increased by their individual shares of the liability the partnership has assumed

Application - 2

In return for a 20% partnership interest, Skinner contributed $5,000 cash and land with a $12,000 basis and a $20,000 fair market value to the partnership. The land was subject to a $10,000 mortgage that the partnership assumed. In addition, the partnership had $20,000 in recourse liabilities that would be shared by partners according to their partnership interests. What amount represents Skinner's basis in the partnership interest?

a. $27,000
b. $21,000
c. $19,000
d. $13,000

(d) The basis of the partner's interest resulting from a contribution of property is the sum of the amount of money contributed, the adjusted basis of property and services contributed, and any gain recognized by the partner. A decrease in a partner's share of partnership liabilities is treated as a distribution of money to the partner; an increase in a partner's share of partnership liabilities is treated as a contribution of money by the partner.

Cash	$	5,000
Add: Adjusted basis of land		12,000
Less: Debt relief		(10,000)
Add: Partnership debt assumed [($10,000 + $20,000) × 20%]		6,000
Initial basis of partnership interest (not below zero)	$	13,000

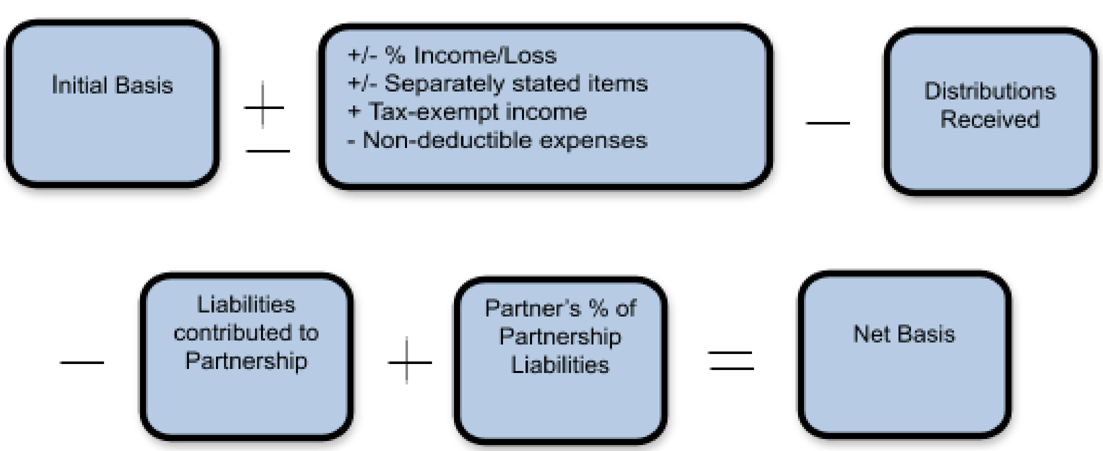
Holding Period

A partner's holding period for a partnership interest acquired through contribution of a capital asset or an asset used in the partner's trade or business includes the holding period for the contributed property. If the contributed property is not a capital asset or used in the partner's trade or business, her/his holding period in the partnership interest begins on the date that the interest is acquired.

Partnership's Basis in the Contributed Assets (Inside Basis)

The basis that the partnership itself has in the asset it owns. Also, referred to as inside basis. The partnerships basis in the contributed property is the partner's carryover basis, or carryover basis including any gains recognized if any special election is made.

Partner's Basis in Partnership (Outside Basis)



Partner's Basis refers to the amount the partner has at risk in the partnership. There is a categorical difference between Partner's basis in Partnership and Partner's Equity or Capital Account as partner's basis includes the partner's share of partnership liabilities to creditors.

Subsequent Adjusted Basis of Partnership Interest

- **Distributive Share** The adjusted basis is increased by the partner's share of income and reduced by her/his share of losses (i.e., her/his distributive share) [IRC §705(a)].

- **Distributions** The adjusted basis is reduced by actual distributions to the partner. The amount of the distribution is generally the amount of money distributed and the adjusted basis to the partnership of any other property distributed [IRC §733].

Application - 3

Dean is a 25% partner in Target Partnership. Dean's tax basis in Target on January 1, Year 1, was $20,000. At the end of Year 1, Dean received a non-liquidating cash distribution of $8,000 from Target. Target's accounts recorded municipal bond interest income of $12,000 and ordinary income of $40,000 for the year. What was Dean's tax basis in Target on December 31, Year 1?

a. $15,000
b. $23,000
c. $25,000
d. $30,000

(c) Dean's basis in his partnership interest is increased by his distributive share of the partnership's ordinary and tax-exempt income. His basis in the partnership interest is reduced, but not below zero, by cash distributions.

Basis, January 1	$ 20,000
Plus: Share of municipal bond interest ($12,000 × 25%)	3,000
Plus: Share of ordinary income ($40,000 × 25%)	10,000
Equals: Basis before distribution	$ 33,000
Less: Distribution	(8,000)
Basis, December 31	$ 25,000

- **Liabilities** The partner's share of liabilities affects her/his adjusted basis.

  ✔ An increase in a partner's share of liabilities of the partnership, or an increase in the partner's liabilities due to the partner's assumption of the partnership's liabilities, is considered a contribution of money by the partner and, thus, will increase her/his basis in her/his partnership interest [IRC §752(a)].

  ✔ A decrease in a partner's share of liabilities of the partnership, or a decrease in the partner's liabilities due to the partnership's assumption of the partner's individual liabilities, is considered a distribution of money to the partner by the partnership and, thus, will result in a decrease in the basis of her/his partnership interest (but not below zero) [IRC §752(b)].

Example - 4 Partner's Basis

Partner X contributes property worth $20,000 with a basis to her of $14,000, subject to liabilities of $16,000, to a new partnership in exchange for a 50% interest in partnership profit, loss, and capital. Y contributes $4,000 of cash to the partnership. The bases for X's and Y's partnership interests are computed as follows.

X's basis in the contributed property [IRC §722]	$ 14,000
Plus X's 50% share of partnership liabilities [IRC §752(a)]	8,000
Less liability subject to which the partnership acquires the property [IRC §752(b)]	(16,000)
Initial basis of X's partnership interest	$ 6,000
Y's basis in the contributed property [IRC §722]	$ 4,000
Plus Y's 50% share of partnership liabilities	8,000
Initial basis of Y's partnership interest	$ 12,000

Partner's Basis cannot be Negative

If a partner's share of loss reduces the partner's basis in partnership below zero, the portion of loss is not deductible. If distribution reduces the partner's basis below zero, the partner will either adjust the basis of the distributed asset or, in the case of cash distributions, report a gain from the distribution and in case of contributed asset subject to higher liability a gain is reported.

Example - 5 Partner's Basis Cannot be Negative

Dev gets a 10% interest in Apple Partnership by contributing a building with a Fair Market Value $100,000, carryover basis of $60,000 subject to a mortgage of $75,000 which the partnership assumes.

Dev's basis in the contributed property	$ 60,000
Less: Liability subject to which the partnership acquires the property	(75,000)
Add: Proportionate Partnership's Liabilities	7,500
Net basis of Dev's partnership interest	$ 0 ($7,500 gain)

Partnership Transactions

Partnership's Distributions

Distribution of assets from the partnership to a partner reduces that partner's basis in the partnership. Partnership distributions are of two types:

- **Non-Liquidating:** Partner continues in the Partnership after the distribution. Generally, a non-liquidating distribution reduces the partner's basis by Net book value of the asset distributed. Distribution can be either in cash or in Property.

  ✔ **Property:** The basis of property distributed to a partner in a non-liquidating distribution is equal to the basis of such property in the partnership's hands immediately before the distribution However, the basis of the property distributed may not exceed the basis of the partner's interest in the partnership. In that case, the basis of the asset is limited to partner's basis in partnership. No gain is recognized.

✔ **Cash:** If cash distribution exceeds partner, excess of cash over basis is recognized as gain by partner in the individual tax return.

Example - 6 Non-liquidating Distribution

Partnership CD distributes to partner D $3,000 cash and equipment with a FMV of $10,000 and a basis of $5,000. D's basis in his partnership interest was $7,000 immediately prior to the distribution. His basis in the equipment is $4,000, computed as follows.

D's basis in partnership interest prior to distribution	$	7,000
Less cash distributed to D		(3,000)
IRC §732(a)(2) limitation on the basis of noncash assets distributed	$	4,000

Basis of equipment:

Lesser of the asset's basis in the partnership's hands immediately before the distribution ($5,000) or the IRC §732(a)(2) limitation ($4,000)	$	4,000

- **Liquidating**: Liquidating distribution are in settlement of entire partnership interest. Partner's basis in the partnership must be reduced to zero after the distribution. There could be various reasons for liquidating distributions such as retirement, death or complete withdrawal by a partner. The proportionate share of partner's profit or loss up till the date of withdrawal must be included in the basis.

  ✔ **Property**: The basis of the distributed asset is always deemed to be equal to the partner's basis in the partnership prior to the liquidating distribution after adjustment for cash such that the basis after the distribution must equal to zero. No gain or loss is recognized.

  ✔ **Cash & Unrealized Receivable**: The difference between cash received and basis in partnership prior to distribution is recognized as gain or loss and the basis adjusted to zero post distribution.

Example - 7 Liquidating Distribution

Partnership XYZ distributes $12,000 cash and a computer, with a FMV of $7,000 and a basis of $3,000, to Y in liquidation of Y's interest in the partnership. If Y's basis in his partnership interest immediately before the distribution is equal to $25,000, his basis in the computer (assuming that XYZ has no liabilities) is equal to $13,000, (i.e., $25,000 basis in Y's partnership interest less $12,000 cash received in the distribution.)

Transfer of Partnership Interest

The gains or losses from the sale or exchange of partnership interests, and gains or losses recognized on partnership distributions or liquidation, generally are characterized as capital gains or losses. Any gain or loss attributable to unrealized receivables or inventory items is ordinary in character.

- **Calculation** The amount that a partner realizes on the sale of a partnership interest includes any cash received, plus any partnership liabilities that are assumed by the buyer.

- **Distributive Share** Distributions must bear a *pro rata* share of these ordinary income items. If not, the transaction is recast as if there were such a *pro rata* distribution followed by a taxable exchange of properties, to achieve the result of the actual distribution.

- **Unrealized Receivables** Unrealized receivables are primarily those amounts due for property or services previously provided, but not yet included in income. A typical example is the accounts receivable of a cash-basis partnership. Unrealized receivables also include any potential depreciation recapture in the partnership assets.

- **Inventory:** Inventory items are those items that, if sold by the partnership, would produce ordinary income.

Cash Proceeds
Partnership Liabilities assumed by buyer
Total Amount Realized
<Partner's Basis>
Gain/Loss

Application - 4

On December 31, after receipt of his share of partnership income, Clark sold his interest in a limited partnership for $30,000 cash and relief of all liabilities. On that date, the adjusted basis of Clark's partnership interest was $40,000, consisting of his capital account of $15,000 and his share of the partnership liabilities of $25,000. The partnership has no unrealized receivables or substantially appreciated inventory. What is Clark's gain or loss on the sale of his partnership interest?

a. Ordinary loss of $10,000
b. Ordinary gain of $15,000
c. Capital loss of $10,000
d. Capital gain of $15,000

(d) The amount that a partner realizes on the sale of a partnership interest includes any cash received, plus any partnership liabilities that are assumed by the buyer. $30,000 cash plus $25,000 liability relief equals $55,000 amount realized. $55,000 amount realized less $40,000 basis equals $15,000 gain. Gains from the sale of partnership interests generally are characterized as capital gains, unless attributable to unrealized receivables or inventory items.

Section 754 Election

Section 754 allows a partnership to adjust the basis of partnership property when property is distributed or when a partnership interest is transferred and thus reconcile a new partner's outside and inside basis in the partnership.
When certain distributions from the partnership to a partner occur or when there is a transfer of a partnership interest by sale or exchange or upon death of partner, partnership will have an option to make a Section 754 election which allows for a Section 743 (b) adjustment that is equal to the difference between the outside basis to the transferee partner and her share of partnership's inside basis of asset. This election is optional unless in case of substantial built-in loss which exceeds $250,000 or more.

Purchase Price
<Inside Basis>
743(b) Adjustment

Partnership Dissolution

Termination

Terminated partnership must file a final return that covers the period up to the date of termination

- **Merger** In a merger, the resulting partnership is a continuation of the merging partnership whose partners have a more than 50% interest in the resulting partnership.
- **Division** In a division, a resulting partnership is a continuation of the prior partnership if the resulting partnership's partners had a more than 50% interest in the prior partnership.
- **Electing Large Partnership:** Electing termination for large partnerships over 100 partners
- **Discontinuance:** Operations of the business are discontinued
- **Sole Proprietorship:** Business is reduced to one partner

Electing Large Partnerships

Generally, an electing large partnership (ELP) is a partnership with 100 or more partners in the preceding taxable year that elects the simplified flow-through provisions. The election applies to all subsequent years and may be revoked only with IRS consent. For tax purposes, an ELP will not terminate merely due to the sale or exchange of 50% of its interests within a 12-month period. If substantially all the partners perform services or the partnership's principal business is commodity trading, the partnership is ineligible for the simplified flow-through provisions.

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