Chapter Ten

**Partnership Taxation**

**Learning Objective 10.1 Nature of Partnership Taxation**

Partnership tax returns are prepared to show information regarding the amount of income by type and the allocation of the income to partners. The income from partnerships is passed through to the partners and they are taxed at their individual rate. Partnership income is taxable to the partner even if the partner did not receive the income. While partnership returns are informational, the returns show important elections made by the partnership, such as depreciation methods and inventory valuation methods.

Partnerships are defined by tax law as a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation or venture is carried on, and which is not classified as a corporation, trust or estate. Generally, limited partnerships and limited liability companies (LLCs) are treated as partnerships according to tax law. Limited partnerships have both general partners and limited partners. General partners participate in management and have unlimited liability for partnership liabilities. Limited partners do not participate in management and have liability limited by the amount of capital. LLCs are entities that combine the limited liability of corporations and the tax treatment of partnerships.

###### Learning Objective 10.2 Partnership Formation

Typically, a partnership or any partners recognize no gain or loss when property is contributed to a partnership in exchange for interest in the partnership. However, if services are performed, then income must be recognized. A partner’s original basis in a partnership interest is equal to the basis of the property transferred to the partnership and any cash contributed to the partnership. The basis of a partner’s interest will change due to partnership activities. Increases are caused by additional contributions to the partnership, net ordinary taxable income of the partnership and capital gains and other income of the partnership. The basis will decrease by distributions of partnership property, losses from operations of the partnership and capital losses and other deductions. Additionally, changes in partnership liabilities can affect the basis.

### Learning Objective 10.3 Partnership Income Reporting

Partnerships report income and other items on a Form 1065, even though the entity does not pay federal income tax. The tax return is due on the fifteenth day of the fourth month following the end of the tax year. Schedule K-1 of Form 1065 allocates the ordinary income or loss, special income and deductions, and gains and losses to each partner. Each partner reports the amounts from the K-1 on their personal tax return. A partner’s deductible loss is limited to the basis of the partner’s interest at the end of the year of the loss. Any unused losses may be carried forward and reported in a future year.

### Learning Objective 10.4 Current Distributions and Guaranteed Payments

A partnership may make distributions in cash or other property to the owners. Guaranteed payments are payments made to a partner in exchanges for services rendered or for the use of the partner’s capital without regard to the income of the partnership.

### Learning Objective 10.5 Tax Years

Partnerships must adopt the same taxable year as that of the majority partners. If those partners have various tax years, then the principal partners will determine the tax year. Once established, the partnership may not close the tax year early unless the partnership is terminated.

**Learning Objective 10.6 Transactions Between Partners and the Partnership**

Losses are disallowed for transactions between a partner and the partnership if the partner has a direct or indirect capital or profit interest in the partnership of more than 50 percent and the transactions between two partnerships owned by more than 50 percent by the same partners. Indirect ownership refers to transactions between a taxpayer and his or her spouse, siblings, ancestors and lineal descendants.

**Learning Objective 10.7 The At-Risk Rule**

The at-risk rule focuses on preventing taxpayers from deducting losses from activities in excess of their investment in the activity. The at-risk rule looks at nonrecourse liabilities and encumbered property. Nonrecourse liabilities are debts for which the borrower is not personally liable. Encumbered property is property pledged as collateral for debts. Taxpayers can use the money obtained from nonrecourse liabilities and, if they default on the liabilities, the encumbered property is seized by the lending source. Thus, the resulting loss should not be a deduction because the taxpayers were aware of the risk. The at-risk rule limits the deduction for losses allocable to a business activity to the extent of income received or accrued from the activity without regard to the amount at risk or the taxpayer’s amount at risk at the end of the tax year.

Learning Objective 10.8 Limited Liability Companies

A limited liability company (LLC) is a hybrid of a partnership and a corporation. Each owner has limited liability, like a corporate stockholder, but the LLC is treated as a partnership for tax purposes. Some of the advantages of a LLC are as follows:

1. Taxable income and losses pass through to owners, thus eliminating double taxations
2. There is no general partner requirement
3. Owners of LLCs can participate in management
4. Ownership of an LLC is not necessarily a security, thereby limiting accounting and legal requirements
5. Tax attributes of an LLC transaction pass through to owners
6. There is greater flexibility than an S Corporation.

Two disadvantages of LLCs are:

1. There is a limited amount of court cases dealing with LLCs since it is a fairly new entity
2. The treatment of LLCs varies from state to state.