Chapter Ten

**Partnership Taxation**

**Learning Objective 10.1 Nature of Partnership Taxation**

Partnership tax returns show information regarding the amount of income by type and the allocation of the income to partners.

* Income from partnerships is passed through to the partners on a Sche;dule K-1
* Individuals use to report their income - income 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 and is is not classified as a corporation, trust or estate.

* Generally, limited partnerships (LLPs) and limited liability companies (LLCs) are treated as partnerships according to tax law.

###### Learning Objective 10.2 Partnership Formation

Typically, no gain or loss recognized when property is contributed to a partnership in exchange for interest in the partnership.

* But, if services are performed, then income must be recognized
* *A partner’s original basis in a partnership interest* = basis of the property transferred to the partnership + cash contributed to the partnership
* Basis of a partner’s interest will change due to partnership activities.
  + Increases = additional contributions to the partnership, net ordinary taxable income of the partnership and capital gains and other income of the partnership
  + Decreases = 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.

### A partner’s basis *in property contributed to the partnerships* = the partner’s adjusted basis at time of contribution plus any gain recognized by the partner.

### Learning Objective 10.3 Partnership Income Reporting

Form 1065 used to report partnership income and expense items

* Entity does not pay federal income tax
* Form 1065 due on the 15th day of the fourth month following the end of the tax year
* Schedule K-1 of Form 1065 allocates ordinary income/loss, special income/deductions, and gains/ losses to each partner
* Each partner reports the amounts from the K-1 on his/her personal tax return
  + A partner’s deductible loss is limited to basis of partner’s interest at the end of the year
  + Unused losses may be carried forward and reported in a future year
  + Banks and online payments networks (like PayPal), must report credit card sales to the IRS on a Form 1099-K, if sales exceed $20,000 and the total number of transactions exceed 200

### 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*
* Guaranteed payments may trigger a loss for the partnership

### Learning Objective 10.5 Tax Years

Partnerships must adopt same taxable year as that of the majority partners

* Unless a compelling business purpose can be established
* If those partners have various tax years, then principal partners will determine tax year
* Once established, the partnership may not close 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*

(1) if the partner has a direct or indirect capital or profit interest in the partnership of more than 50% and

(2) transactions between two partnerships owned by more than 50% by the same partners

Any gains are taxed as ordinary income. 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 - the amount at risk is adjusted basis of property if he/she is personally liable for debt repayment
  + At risk amount = cash/property contributed + liabilities to extent of property pledged + personal liabilities/retained profits of the activity.
  + The at-risk rule limits the deduction for losses allocable to a business activity to the extent of (1) income received or accrued from the activity without regard to the amount at risk, or (2) 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:
  + Taxable income and losses pass through to owners, thus eliminating double taxation
  + There is no general partner requirement
  + Owners of LLCs can participate in management
  + Ownership of an LLC is not necessarily a security, thereby limiting accounting and legal requirements
  + Tax attributes of an LLC transaction pass through to owners
  + There is greater flexibility than an S Corporation
* Two disadvantages of LLCs are:
  + There is a limited amount of court cases dealing with LLCs since it is a fairly new entity
  + The treatment of LLCs varies from state to state.