**Chapter 9 Notes**

**Forming and Operating Partnerships**

Chapter overview

**I. Overview: Flow-Through Entities**

* + - * Also called pass-through entities
* Generally, income earned is not taxed at the entity level.
* Owners are taxed on their share of entity-level income allocated to them.

- single-level of tax: at the owner level

- contrast with C corporations: double taxation

* Unincorporated business entities: general partnerships, limited partnerships, and limited liability companies (LLC):
* treated as partnerships under Subchapter K of the IRC.
* Subchapter S: corporations whose owners elect to treat them as flow-through entities (discuss in chapter 11).

**II. Overview of Partnership Taxation**

*What is a partnership?*

* association formed by two or more persons to carry on a trade or business, with each contributing money, property, or services, and with all expecting to share in the profits and losses.

(unincorporated entity with a single owner is a sole proprietorship)

* must be unincorporated
* cannot be classified as a corporation, estate, or trust
* defined and formed under state law

*Types of Partnerships*

* distinguished by the classification of the partners as general or limited partners
* general partners – materially participate in managing the partnership;

– legally responsible for repayment of partnership recourse debt

* limited partners – may not participate in managing the partnership;

– only liable for partnership debts to the extent of any unpaid contributions contractually agreed upon.

General Partnership (GP): 1) consists of two or more partners who are general partners (no limited partners); AND

2) participate in management of the partnership.

Limited Partnership (LP): 1) consists of at least one general partner; AND

2) one or more limited partners

Limited Liability Partnership (LLP): similar in form to a GP but partners are not held personally liable for malpractice committed by other partners. Most accounting firms use this entity form.

Limited Liability Limited Partnership (LLLP): an extension of the LP form in which all partners (general and limited) have limited liability.

Limited Liability Company (LLC):

- combines corporate benefit of limited liability with partnership benefit of single level of tax

- owners are referred to as “members”

- members generally participate in managing the entity

- for purposes of debt, members are treated as limited partners (i.e., limited liability)

- each member’s losses are limited to the member’s contributed capital

Partnership agreement – governing agreement for the partnership.

* outlines the rights and obligations of each partner;
* allocation of income, deductions, and cash flows;
* initial future capital contribution requirements;
* conditions for terminating the partnership; and
* other matters.
* must be signed by each partner.

Operating agreement – governing agreement for the LLC.

* similar structure to a partnership agreement.

**See summary template of flow-through entities at end of notes.**

*Taxation of Partnerships*

* pays no federal income tax
* taxable in some states (franchise tax, fees, or other taxes)
* income and loss flow through to the partners
* partners report their share of income and loss on their individual income tax returns
* whether or not the partnership distributes cash to the partners
* withdrawals by, and distributions to, partners are non-taxable
* taxable if it exceeds partner’s basis in the partnership
* governed by an aggregate approach and an entity approach
* *aggregate approach*: treat partnerships simply as an aggregation of the partners’ separate interests in the assets and liabilities of the partnership (e.g., income tax imposed on the partners, not the partnership).
* *entity approach*: tax partnerships as entities separate from their partners (e.g., partnership must file an information return that summarizes its activities for the year).

**III. Partnership Formations and Acquisitions of Partnership Interests**

*Organization, Start-Up, and Syndication Costs*

capitalized and expensed over the partnership’s life.

organization costs: expenses associated with legally forming a partnership (accountant and attorney fees)

start-up costs: expenses associated with starting a business (employee training, advertising)

syndication costs: expenses incurred to promote and sell partnership interests

- non-deductible

- usually incurred by public (not closely-held) partnerships

When a partnership is formed, and afterwards, partners may transfer cash, other tangible or intangible property, and services to it in exchange for an equity interest called a partnership interest.

* partnership interest – represents the bundle of economic rights granted to partners under the partnership agreement (or operating agreement for an LLC).
* economic rights: 1) capital interest – right to receive a share of the partnership net assets if the partnership were to liquidate; and

2) profits interest – right or obligation to receive a share of *future* profits or *future* losses

- partners contributing property usually receive both capital and profits interests

- partners contributing services usually receive only profits interest

*Contributions of Property*

non-taxable transaction – from a practical perspective, deferral allows entrepreneurs to organize their business without having to pay taxes.

- property: includes a wide variety of both tangible and intangible assets, but not services

Gain and loss recognition

* partnerships nor partners recognize gain or loss

- applies to both initial and subsequent contributions

Example 1: Debbie, Jennifer, and Shottaz, Inc. form Blazer, Inc., a limited liability company (LLC). Assume Debbie contributes land to Blazer, Inc. with a FMV of $120,000 and an adjusted tax basis of $20,000. What amount of gain or loss would she recognize on the contribution?

$0. Debbie does not recognize any of the $100,000 BIG from her contributed land.

Suppose Shottaz, Inc. contributed equipment with a FMV of $120,000 and an adjusted tax basis of $220,000 to Blazer, Inc. What amount of gain or loss would Shottaz, Inc. recognize on the contribution?

$0. Shottaz, Inc. would not recognize any of the $100,000 BIL on the equipment.

*Partners’ Initial Tax Basis*

(partners need to keep track of the tax basis in their partnership interests to properly compute their taxable gains and losses when they sell their partnership interests).

* outside basis: partner’s tax basis in her partnership interest
* inside basis: partnership’s basis in its assets
* if partnership has no debt:
* partner’s tax basis = basis of property and cash contributed.

Example 2: Assume Jennifer contributed $120,000 in cash to Blazer, Inc. in exchange for her partnership interest and that Blazer, Inc. had no liabilities. What is Jennifer’s outside basis in her partnership interest after the contribution?

$120,000: the amount of cash she contributed

Assume Debbie contributed land with a FMV of $120,000 and an adjusted basis of $20,000 and Blazer, Inc. had no liabilities. What is Debbie’s initial tax basis in Blazer, Inc.?

$20,000: the basis of the property she contributed. If she immediately sold her interest in the partnership for $120,000, she would recognize $100,000 gain.

* if partnership has debt:
* partner’s tax basis = (basis of contributed property and cash – debt securing contributed property + partnership debt allocated to contributing partner + gain recognized)

- each partner increases the tax basis in her proportionate share of partnership interest.

- partnership tax law treats each partner as borrowing her proportionate share of the partnership’s debt and then contributing the borrowed cash to acquire her partnership interest.

Types of Partnership Debt

* recourse debt:

- allocated to partners with ultimate responsibility of paying debt

- partners have economic risk of loss, i.e., they have to legally satisfy the debt with their own funds (e.g., payables – unsecured debt of the partnership)

- typically allocated to general partners in a LP (because limited partners are legally protected from a LP’s recourse debt holders)

* nonrecourse debt:

- debt for which no partner bears an economic risk of loss.

- allocated according to partners’ profit-sharing ratios

- example: mortgage on real property

- LLC members generally treat LLC debt as nonrecourse because this entity type (like a corporation) shields members from the LLC’s creditors.

Example 3: Jennifer and Shottaz, Inc. initially contributed $120,000 each to Blazer Inc. and Blazer Inc. borrowed $60,000 from a bank when it formed. The bank required all three members to personally guarantee the bank loan. The terms of the loan were structured so the members would each be responsible for a portion of the debt equal to the percentage of Blazer, Inc. losses allocated to each member (one-third each). How much of the $60,000 bank debt was allocated to each member? How is the debt classified (recourse or nonrecourse)?

$20,000 allocated equally to each member as recourse debt because each member personally guaranteed it.

Assume the $60,000 bank loan is Blazer, Inc.’s only debt. What is Jennifer’s initial basis in her Blazer, Inc. interest after taking her share of Blazer’s bank debt into account?

$140,000 = ($120,000 + $20,000) 🡨 cash contribution + share of recourse debt

What if the partnership assumes debt of the partner secured by property the partner contributes to the partnership?

- contributing partner must treat her debt relief as a deemed cash distribution from the partnership, which reduces her outside basis.

- if debt is nonrecourse: amount of debt in excess of the basis of the contributed property is allocated solely to the contributing partner;

- the remaining debt is allocated to all partners according to their profit-sharing ratios.

Example 4: Assume Debbie contributed $10,000 of cash and land with a FMV of $150,000 and adjusted basis of $20,000 to Blazer, Inc. when it was formed. The land was encumbered by a $40,000 nonrecourse mortgage executed three years before. Recall that Blazer already has $60,000 in bank debt before Debbie’s contribution. What are the initial tax bases of the three members in their Blazer interests?

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| --- | --- | --- | --- | --- |
| **Description** | **Debbie** | **Jennifer** | **Shottaz Inc.** | **Explanation** |
| (1) basis in contributed land | $ 20,000 |  |  |  |
| (2) cash contributed | 10,000 | $ 120,000 | $ 120,000 | example 3 |
| (3) member’s share of $60,000 recourse bank loan | 20,000 | 20,000 | 20,000 | example 3 |
| (4) nonrecourse mortgage in excess of basis in contributed land | 20,000 |  |  | nonrecourse debt > basis in contributed property --- allocated only to Debbie |
| (5) remaining nonrecourse mortgage | 6,666 | 6,666 | 6,666 | 33.33% x [$40,000 – (4)] |
| (6) relief from mortgage debt | (40,000) |  |  |  |
| **members’ initial tax basis in Blazer, Inc.** | **$ 36,666** | **$ 146,666** | **$ 146,666** | **sum of (1) though (6)** |

Exception to the general rule of non-recognition of gains on contributed property secured by debt

- contributing partner recognizes gain *only if* the relief of debt exceeds the contributing partner’s tax basis in her partnership interest prior to the relief of debt.

- any gain recognized is treated as a capital gain

Example 5: Assume Jennifer and Shottaz, Inc., but not Debbie, personally guarantee all $100,000 of Blazer, Inc.’s debt ($60,000 bank loan + $40,000 mortgage on land). How much gain, if any, would Debbie recognize on her contribution to Blazer and what would be the basis in her Blazer interest?

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| **Description** | **Amount** | **Explanation** |
| (1) basis in contributed land | $20,000 | example 4 |
| (2) cash contributed | 10,000 | example 4 |
| (3) Debbie’s share of debt | 0 | Jennifer and Shottaz guaranteed all of Blazer’s liabilities, including the mortgage on land, thereby turning them into recourse liabilities that should only be allocated to Jennifer and Shottaz. |
| (4) debt relief | (40,000) | Debbie was relieved of mortgage on land. |
| (5) debt relief in excess of basis in contributed land and cash | (10,000) | sum of (1) through (4) |
| **(6) capital gain recognized** | **10,000** | (5) with opposite sign |
| **Debbie’s initial tax basis in Blazer** | **0** | (5) + (6) |

*Partner’s Holding Period in Partnership Interest*

Because a partnership’s interest is a capital asset, its holding period determines whether gains or losses from the disposition of the partnership interest are short-term or long-term capital gains or losses.

* depends on the nature of the assets the partner contributed
* capital assets or §1231 assets: holding period “tacks on” to the partnership interest

(§1231 assets – assets used in a trade or business and held for more than one year)

* otherwise, it begins on the day the partnership interest is acquired

Example 6: Assume Debbie contributed land held for investment (no cash) that she had held for five years in exchange for her partnership interest. Two months after contributing the property, she sold her partnership interest and recognized a capital gain. Is the gain long-term or short-term?

long-term – the 5-year holding period of the land is tacked on to Debbie’s holding period in her partnership interest. She is treated as though she held the partnership interest for five years and two months at the time she sold it.

*Partnership’s Tax Basis and Holding Period in Contributed Property*

Just as partners must determine their initial outside basis in their partnership interest after contributing property, partnerships must also establish their inside basis in the contributed property (consistent with the entity theory).

* basis in property = contributing partner’s basis in the property at the time of the contribution
* ensures built-in gains and built-in losses on contributed property are ultimately recognized if the partnership sells the contributed property.
* holding period = contributing partner’s holding period in the property contributed
* character of the property contributed – depends on how the partnership uses the contributed property (i.e., whether gains and losses on dispositions of contributed property are capital or ordinary).

Example 7: Assume Blazer, Inc. used the land Debbie contributed in its business for two months and then sold it for its FMV of $150,000. What is the amount and character of the gain Blazer would recognize on the sale (see example 4 for basis)?

$130,000 §1231 gain.

Blazer receives Debbie’s carryover basis in the land for $20,000 and carryover holding period of 5 years:

proceeds: $150,000

less: A/B: (20,000)

LTG $130,000

*Contribution of Services*

* may create immediate tax consequences to both the contributing partner and the partnership;

- depends on the nature of the partnership interest received, i.e., capital interest or profits interest

*Partnership Books and Records*

Partnerships track the equity of each partner using a capital account. The type of capital account used depends on the approach the partnership uses to prepare its financial statements.

Types of Capital Accounts

* GAAP capital account – used by partnerships that prepare its financial statements using generally accepted accounting principles.

partnerships not required to produce GAAP financial statements may decide to use inside tax basis, and tax revenue and recognition rules, to maintain its books. Under this approach the partnership would prepare its initial balance sheet using the tax basis for its assets.

* tax capital account – partnership prepares one for each partner which reflects the tax basis of any property contributed (net of any debt securing the property) and cash contributions.

- measures the partner’s equity in the partnership

- adjusted to include the partner’s share of earnings and losses, contributions, and distributions

* 704(b) capital account – (another alternative to GAAP capital account) similar to tax capital accounts, except contributed assets are recorded at FMV rather than tax basis

(better measure of the true value of partners’ capital interests; many partnership agreements require the partnership to maintain §704(b) and tax capital accounts)

Example 8: Before forming Blazer, Inc., its members agreed to keep its books using the tax basis of contributed assets and tax income and expense recognition rules. After receiving the cash and property contributions from its members and borrowing $60,000 from Debbie’s bank, Blazer, Inc. hired you as their tax accountant to prepare the tax basis balance sheet. Because you know that maintaining §704(b) balance sheet provides a better measure of the true value of the partners’ capital interests, you also prepare the §704(b) balance sheet as follows:

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| --- | --- | --- |
| **Blazer, Inc.**  **Balance Sheet**  **March 31, 2019** | | |
|  | **Tax Basis** | **§704(b)/FMV** |
| **Assets:** |  |  |
| Cash | $310,000 | $310,000 |
| Land | 20,000 | 150,000 |
| Totals | $330,000 | $460,000 |
|  |  |  |
| **Liabilities and Capital** |  |  |
| Long-term debt | $100,000 | $100,000 |
| Capital – Debbie | (10,000) | 120,000 |
| Capital – Jennifer | 120,000 | 120,000 |
| Capital – Shottaz, Inc. | 120,000 | 120,000 |
| Totals | $330,000 | $460,000 |

**IV: Partnership Accounting: Tax Elections, Accounting Methods, and Accounting Periods**

Key Facts:

* partnerships are responsible for making most tax elections (e.g., election of accounting method).
* partnership’s taxable year is the majority interest taxable year, the common taxable year of the principal partners, or the taxable year providing the least aggregate tax deferral to the partners.
* partnerships are generally eligible to use the cash method unless they have gross receipts greater than $5 million and have corporate partners.

**V: Reporting the Results of Partnership Operations**

*Reporting and Compliance*

* files federal **Form 1065**, U.S. Return of Partnership Income with the IRS
* due date: 15th day of the 3rd month after the partnership’s year-end.
* **Schedule K**: lists the partnership’s ordinary business income (loss) and separately stated items (e.g., charitable contributions)
* **Schedule K-1**: reports each partner’s individual share of the partnership’s ordinary business income (loss) and separately stated items for the year.

Key Facts:

* partnerships file annual information returns (Form 1065) reporting their ordinary business income (loss) and separately stated items.
* ordinary business income (loss) = partnership overall income or loss exclusive of separately stated items.
* separately stated items change partners’ tax liabilities when they are separately stated.

- share a common characteristic: they are treated differently from a partner’s share of ordinary business income (loss) for tax purposes (e.g., dividend income and capital losses).

*Ordinary Business Income and Separately Stated Items*

When gathering information for their partners, the partnership must determine each partner’s share of ordinary business income (loss) and separately stated items.

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| **Common Separately Stated Items** | |
| Interest income | Net rental real estate income |
| Guaranteed payments | Investment interest expense |
| Net earnings (loss) from self-employment | Charitable contributions |
| Tax-exempt income | §179 deduction |

Guaranteed payments – fixed amounts paid to partners regardless of whether the partnership shows a profit or loss for the year.

* economically equivalent to cash salary payments made to partners for services provided.

**VI. Partner’s Adjusted Tax Basis in Partnership Interest**

Earlier in the notes we discussed how partners measure their initial tax basis in their partnership interest. Because the basis in a partnership is dynamic, it must be adjusted as the partnership generates income and losses, changes in debt levels, and makes distributions to partners.

Key Facts (order matters):

* A partner increases the tax basis in her partnership interest for:
* Contributions
* Share of ordinary business income
* Separately stated income/gain items
* tax-exempt income
* A partner decreases the tax basis in her partnership interest for:
* Cash distributions
* Share of nondeductible expenses
* Share of deductible expenses
* Share of ordinary business loss
* Separately stated expense/loss items
* A partner’s tax basis may not be negative.
* Losses allocated in excess of a partner’s basis must be suspended and carried forward indefinitely until the partner has sufficient basis to utilize the losses.
* Partners may create additional tax basis in the future by:

1) making capital contributions;

2) guaranteeing more partnership debt; and

3) helping their partnership to become profitable.

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| **SUMMARY OF FLOW-THROUGH ENTITY TYPES** | | | | |
| **Type of entity** | **Type of owners** | **Are owners liable for entity debts?** | **May owners participate in entity management?** | **Types of businesses operated by entity\*** |
| General partnership (GP) | General partners only | Yes, recourse to GP  No, debt secured only by property | Yes | Operating businesses, and joint ventures formed by other operating businesses |
| Limited partnership (LP) | Limited partners plus at least on general partner\*\* | Yes, for general partners  No, for limited partners | Yes, for general partners  No, for limited partners | Entities raising capital from investors |
| Limited liability company (LLC) | Members have some general and some limited characteristics | No | Yes, generally, but many operating agreements limit participation by some member classes | Operating businesses, non-professional service businesses, and some professional service businesses |
| Limited liability partnership (LLP) | General partners with limited liability for malpractice committed by other partners. | Yes, for general liabilities, but only responsible for their own malpractice | Yes | Professional service entities such as accounting and law firms |

\* In general; permitted business operations depend on state law.

\*\*The general partner is often a C corporation or LLC, to minimize exposure to entity liabilities.