

Partnerships



Tab B Topics

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BASICS OF PARTNERSHIPS

Form 1065; See also IRS Pub. 541 and Partnership Example on Page B-10

Filing requirements. Every partnership that has income, deductions and/or tax credits for the year must file a return, regardless of the amount of income or loss. If the partnership does not receive income and does not incur any expenses, it is not required to file a return.



Filing deadline. Returns are due by the 15th day of the fourth month following the close of the tax year.

Extension deadline and form number. The extended deadline is five months [Reg. §1.6081-2(a)(1)]. For calendar year 2014 returns, the extended due date is September 15, 2015. File Form 7004 to extend the filing deadline.

Electing large partnerships required to file Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*, are allowed an automatic six-month extension of time to file their returns [Reg. §1.6081-2(a)(2)]. However, these entities are required to furnish Schedule K-1 to their partners no later than March 15 following the close of the tax year. See *Electing Large Partnerships* on Page B-4 for more information.

Electronic filing requirements. Partnerships with more than 100 partners are required to file returns electronically. Other partnerships generally have the option to file electronically. Certain returns may not be filed electronically (for example, those involving bankruptcy or pre-computed penalty and interest). If a partnership can demonstrate that hardship would result from the requirement to file electronically, a waiver may be requested by following procedures in the Form 1065 instructions.

Penalties. The penalty for failure to file a return is \$195 per month or part of a month per partner up to twelve months (IRC §6698). The penalty is assessed against the partnership. *Exception:* The penalty will be abated if the partnership can show reasonable cause for late filing. Domestic partnerships with 10 or fewer partners will generally qualify for the reasonable cause exception if (1) all partners have fully reported their shares of income, deductions and credits on timely filed returns and (2) each partner is an individual (other than a nonresident alien), a C corporation or an estate of a deceased partner. [IRC §6231(a)(1)(B)(i)]

Amended return. Partnerships that become aware of incorrect items of income, deductions, etc. may amend the return. Small partnerships (non TEFRA—see the TEFRA discussion that follows)

filing electronically to amend Form 1065 and Schedules K-1 check the box on page 1 of Form 1065 to indicate that it is an amended return and follow the Form 1065 instructions for statements and explanations that are required. An amended Schedule K-1 should be provided to each partner.

TEFRA partnerships filing electronically use Form 8082 to file an amended return or AAR (Administrative Adjustment Request).

If paper returns are used to correct a previously filed partnership return, both small and TEFRA partnerships use Form 1065X.

What is TEFRA? Under the Tax Equity and Fiscal Responsibility Act (TEFRA), partnership audits are normally required to be conducted at the partnership level rather than dealing separately with each partner in the entity. A partnership with 11 or more partners at any one time during a tax year is treated as a TEFRA partnership (and is thus subject to the consolidated audit rules and the requirement to name a Tax Matters Partner, or TMP). In addition, partnerships with less than 11 partners are also subject to TEFRA if they have any partners who are not U.S. citizens or resident alien individuals, estates or C corporations. [IRC §6231(a)(1)]

Economic substance. Although a basic tenet of tax law is an understanding that taxpayers may structure transactions to minimize tax, a business transaction must exhibit *economic substance*, which includes a reasonable possibility of a profit and a business purpose (other than tax avoidance).

The economic substance doctrine [codified in IRC §7701(o)] has been applied by the courts for many years in determining the deductibility of various transactions in tax cases. Penalty provisions under IRC §6662 and §6664 (accuracy-related penalties on understatements), and §6676 (erroneous refund claim penalties) both include the economic substance doctrine.

Schedule K-1 deadline. Partnerships are required to furnish a Schedule K-1 to each partner by the due date, including extensions, of the partnership tax return (Form 1065). A \$100 penalty, imposed with respect to each Schedule K-1 for which a failure occurs, applies for failure to furnish Schedule K-1 when due or failure to include all required information or for including incorrect information. The \$100 penalty is reduced to \$30 or \$60 per failure, depending on when and whether the failure is corrected (IRC §6722). The maximum penalty ranges from \$250,000–\$1,500,000 (\$75,000–\$500,000 for small businesses). Higher penalties apply if the failure is due to intentional disregard of the law, and the penalties will be adjusted for inflation. See Section 6722 for details.

Electronic Schedule K-1. Partnerships required to furnish a K-1 to a partner may provide it in an electronic format instead of on paper. The partner's affirmative consent to receive the K-1 in electronic format is one of the requirements of Rev. Proc. 2012-17 that must be met for the partnership to be treated as furnishing the K-1 timely.

Income/tax rates. Profits and losses are passed through to partners on Schedule K-1 and taxed on their individual returns.

Limited liability companies (LLCs) are created and regulated under state law. Those with more than one member are treated as partnerships for federal income tax purposes, unless an election is made to be taxed as a corporation. LLCs generally have the same options as partnerships for electing tax treatment under check-the-box regulations. See *Limited Liability Company (LLC)* on Page F-1 for more information.

Tax matters partner (TMP). A partnership's primary representative in dealings with the IRS is its TMP. The partnership may designate its own TMP by completing the requested information on page 3 of Form 1065. The TMP must be a general partner or

member-manager (for an LLC), and in most cases, also a U.S. person. If the partnership does not designate a TMP, the IRS can appoint one.

Note: Partnerships that are not subject to TEFRA (see discussion on Page B-1) do not have TMPs unless they elect to be subject to TEFRA. (See the Form 1065 instructions for more guidance.)

General Partner/Limited Partner

General partner. A partner personally liable for partnership debts.

Self-employment (SE) tax. A general partner's distributive share of ordinary income is subject to SE tax. In addition, guaranteed payments paid to either general or limited partners are subject to SE tax. Certain deductions may be allowed in determining an individual's SE tax. See the *Partnership Example* starting on Page B-10 for an illustration of how to report partnership income on a partner's Schedule E and Schedule SE.

Court Case: A general partner received over \$70,000 as distributive share of partnership income, but did not report or pay any SE tax on the amount. Since the taxpayer only spent about 40 hours during the year on partnership activities, he claimed that his income from the partnership was passive. The Tax Court found that the income was subject to SE tax because the taxpayer was a general partner, regardless of the minimal amount of time spent on partnership activities. (*Norwood*, TC Memo 2000-84)

Note: Only individuals are subject to SE tax. Estates, trusts and corporations are not liable for SE tax. Ordinary income passing from one partnership to another partnership is SE income to individual general partners to whom the income is ultimately distributed.

Limited partner. A partner in a partnership formed under a state limited liability law whose liability for partnership debts is limited to the amount of money or property the partner contributes to the partnership. Limited partners generally are not subject to SE tax on their distributive share of income, unless the income is a guaranteed payment for the performance of services and not for the return of capital. See *Guaranteed Payments* on Page B-6.

Note: In a Chief Counsel Advice (CCA 201436049), the IRS ruled that the members of an LLC (treated as a partnership) that provides investment management services that were not exempt from SE tax on their LLC earnings. This was true even though they had limited liability (like a limited partner in a partnership) because they were actively involved with the business operations.

General partnership. Two or more general partners who join together to carry on a trade or business. Each partner contributes money, property, labor or skills and expects to share in profits and losses. A partner can be an individual, corporation, trust, estate, LLC or another partnership. There can be no limited partners.



Limited partnership. Formed under a state limited liability law and composed of at least one general partner and one or more limited partners. See Tab F for more information about limited partnerships and limited liability partnerships (LLPs).

Partnership Characteristics

A business entity with two or more owners is, by default, classified as a partnership for federal tax purposes (unless the entity is a corporation, estate or trust). A partnership can be a trade or business, financial operation or joint venture.

Co-ownership of property or expense sharing does not necessarily create a partnership. For example, if several sole proprietors share office space, they can pool their funds to pay common expenses such as rent, secretarial services, utilities and building maintenance. This arrangement is not considered a partnership.

However, if they share revenues and/or profits, the arrangement is a partnership.

Rental property co-ownership. Mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity. [Reg. §301.7701-1(a)(2)]

However, if the arrangement has the characteristics of common purpose among owners or limitations on a co-owner's ability to independently sell or lease the interest in the property, or if the co-owners provide more than customary maintenance of the property, a partnership may exist. Revenue Procedure 2002-22 specifies procedures for requesting a ruling on whether an interest in real property constitutes a separate entity for federal tax purposes.

If the arrangement is a partnership, the following apply:

- Assets transferred into the partnership by the partners are considered co-owned by all the partners. No one partner has a claim against a specific asset.
- The lifetime of a partnership is generally limited by the lifetime of each of the partners.
- A partner can bind other partners to a contract as long as the act is within the scope of the partnership's field of business.
- Each general partner is personally liable for all partnership liabilities.

Check-the-Box Regulations

An entity that is classified as a partnership by default can elect to be treated as a corporation for federal tax purposes. See Tab F for information about "check-the-box" regulations.

Spouses as Partners

If spouses operate an unincorporated business together and share in the profits and losses, they have a partnership and should report income and losses on Form 1065 and not Schedule C (Form 1040). However, they can elect not to treat this joint venture as a partnership if they meet the requirements of a Qualified Joint Venture (QJV) [IRC §761(f)], thereby saving the compliance costs of filing a partnership return.

Qualified Joint Venture. By meeting the tests to be a QJV, a married couple can elect either to file as two sole proprietors, reporting the appropriate share of income and expenses on two Schedule Cs, or can continue to (or, for a new business, start to) file a partnership return. To have a QJV, the couple must:

- 1) File a joint return and
- 2) Conduct a trade or business that meets the following criteria:
 - Only a husband and wife are partners or members;
 - Both spouses materially participate under the passive loss rules, without regard to the rule that treats one spouse's participation as participation by the other spouse and
 - Both spouses elect QJV status.

If both spouses make the election, the income is deemed to be earned by each spouse as a sole proprietor.

Practice Tip: A QJV is not required to report income from a rental real estate business as subject to self-employment (SE) tax. Taxpayers should include the amount of net profit from rental real estate on Schedule E, rather than Schedule C. Check the QJV box on line 2 for any rental activity that is a QJV.

Community property states. If the spouses live in a community property state and any income derived from a trade or business is community income (under that state's community property laws), the SE income (or loss) from that business is treated as income of the spouse carrying on business. If both spouses operate the business, the SE income is allocated based on each spouse's participation in the business [IRC §1402(a)(5)(A)]. If the business is operated as a partnership, each partner reports his distributive

Continued on Page B-4

Partnership Income and Expense Chart (Form 1065)

| Category | Description | Where to Report |
|--|---|--|
| Business Expenses in General | Nonrental activity expenses paid by partnership deductible under Section 162; not specially allocated to partners. | Operating expenses are reported on Form 1065, page 1, lines 9 – 20. Cost of goods sold (COGS) expenses are reported on Form 1125-A. |
| Capital Contributions | Cash or property contributed to the partnership by partners in exchange for an interest or additional interest in the partnership. | Schedule M-2, line 2, and Schedule K-1, Part II, Item L. |
| Capital Gains and Losses | Gains and losses from investments such as stocks and bonds. | Form 8949/Schedule D, Form 1065. Carried to Schedules K and K-1, lines 8 and 9. |
| Charitable Contributions | Charitable contributions on behalf of partners. | Schedules K and K-1, line 13 (codes A – G). |
| Depreciation | Property purchased by the partnership. | Form 4562 and Form 1065, page 1, line 16a. Enter on line 16b the amount reported elsewhere on the return such as depreciation included in COGS on Form 1125-A. Reconcile any difference between depreciation per books and depreciation per tax return on Schedule M-1, line 4a or 7a, or M-3. Books prepared on a book basis (FMV) will result in a difference reported on Schedule M-1/M-3. Books prepared on the tax basis should not yield a difference on Schedule M-1/M-3. |
| | Property contributed to the partnership by the partners, when the fair market value (FMV) of the property is different than its adjusted basis at the time it is contributed. | Form 4562 and Form 1065, page 1, line 16a and, if applicable, line 16b. A separate depreciation schedule must be maintained showing depreciation based on FMV and depreciation based on the adjusted basis. Depreciation for book purposes will be based on FMV. Depreciation for tax return purposes will be based on the adjusted basis. Reconcile the difference between depreciation per books and depreciation per tax return on Schedule M-1, line 4a or 7a, or M-3. Books prepared on a book basis (FMV) will result in a difference reported on Schedule M-1/M-3. Books prepared on the tax basis should not yield a difference on Schedule M-1/M-3. |
| Distributions to Partners | Cash or property distributions to partners that are not guaranteed payments for services rendered or for use of capital. | Schedule M-2, line 6, Schedule K-1, Part II, Item L, and Schedules K and K-1, line 19. |
| Farm Income and Expenses | Other than from rental activities. | Schedule F, Form 1040, is attached to Form 1065. The net profit (loss) is carried to Form 1065, page 1, line 5. |
| Goodwill | Amount partnership paid for business assets in excess of FMV. Goodwill can be amortized over a 15-year period. | Form 4562, Part VI. Deductible amortization is carried to line 20, page 1, Form 1065. Book cost is entered on line 12a of Schedule L, and book accumulated amortization is entered on line 12b. |
| Guaranteed Payments | Payments to individual partners for services rendered, or for use of capital to the extent that the payments are not determined by the amount of partnership profits. | Form 1065, page 1, line 10, except for payments required to be capitalized (such as services rendered in organizing or syndicating a partnership). Also enter on Schedules K and K-1, line 4, and Schedule M-1, line 3, or M-3. |
| Health Insurance Premiums | Paid on behalf of partnership employees. | Form 1065, page 1, line 19, or Form 1125-A if employees' wages are included in COGS. |
| | Paid on behalf of partners. | Two choices: (1) report as a guaranteed payment or (2) report as a distribution to the partner. (Rev. Rul. 91-26) |
| Investment Interest Expense | Interest paid or accrued to purchase property held for investment. | Schedules K, line 13b and K-1, line 13, code H. |
| Meals and Entertainment | Expenses subject to the 50% limitation rules. | Deductible portion on Form 1065, page 1, line 20. Nondeductible portion on Schedule M-1, line 4b, or M-3, and Schedules K and K-1, line 18, code C. |
| Organization Fees | Expenses incident to the creation of the partnership are chargeable to a capital account. Deduct up to \$5,000—amount reduced for costs exceeding \$50,000. Remaining costs amortized over 180 months. See <i>Organizational and Start-Up Costs</i> on Page M-6. | Up to \$5,000 is deducted as a current business expense (Form 1065, page 1, line 20). Remainder amortized (over 180 months) on Form 4562, Part VI, and Form 1065, page 1, line 20. Book cost is entered on Schedule L, line 12a, and book accumulated amortization is entered on line 12b. |
| Penalties | Penalties such as late filing of a partnership tax return are not deductible by the partnership or partners under Section 162(f). | Schedules K and K-1, line 18, code C. If expense was recorded in partnership books, also enter on Schedule M-1, line 4, or M-3. |
| Portfolio Income and Expenses | Interest, dividends, royalties, etc. | Schedules K and K-1. Income on lines 5 through 7. Expenses on line 13b or 13d of Schedule K and lines 13 (codes H, I, K and L) and 20 (codes A, B and Y) of Schedule K-1. |
| Rental Activity Income and Expenses | All income and expenses from rental real estate activities that are not considered a trade or business. | Form 8825 and Schedules K and K-1, line 2. |
| | All income and expenses from other rental activities that are not considered a trade or business and are not rental real estate reported on Form 8825. | Schedules K and K-1, line 3. |
| Retirement Plan Contributions | On behalf of partners. | Schedules K and K-1, line 13, code R. |
| | On behalf of partnership employees. | Form 1065, page 1, line 18. |
| Section 1231 Gains and Losses | Gains and losses from: sale or exchange of real or depreciable property used in a trade or business, livestock, timber, unharvested crops, coal, iron ore and certain involuntary conversions. | Form 4797. Ordinary gains and losses carried to page one of Form 1065, line 6. Other gains and losses to Schedules K and K-1, line 10. |
| Section 179 Deduction | The limitations on the Section 179 deduction apply first at the partnership level and then at the individual partner level. | Report first on Form 4562, Part I, for partnership limitations. Do not include on Part IV Summary. Then carry result to Schedules K and K-1, line 12. |
| Start-Up Costs | Amounts paid in connection with creating an active trade or business or for investigating the creation or acquisition of an active trade or business. Start-up expenses must be of a type that could be deducted in the current tax year by an existing trade or business for expansion purposes. See <i>Organizational and Start-Up Costs</i> on Page M-6. | Up to \$5,000 is deducted as a current business expense (Form 1065, page 1, line 20). Remainder amortized (over 180 months) on Form 4562, Part VI, and Form 1065, page 1, line 20. Book cost is entered on Schedule L, line 12a, and book accumulated amortization is entered on line 12b. |
| Syndication Fees | Expenses connected with the issuing and marketing of interests in the partnership, such as commissions, professional fees and printing costs. These expenses are nondeductible and must be capitalized. | Schedule L, line 21 as a reduction of partners' capital accounts. |
| Tax-Exempt Interest | Interest income from municipal bonds, etc. | Schedule M-1, line 6a, or M-3, and Schedules K and K-1, line 18, code A. |
| Trade or Business Income | Other than from rental activities or portfolio income. | Form 1065, page 1. |

share of income as SE income. Determining whether a partnership exists is different for taxpayers in community property states than in separate property states. In community property states, the IRS will respect whichever treatment (sole proprietorship or partnership) the taxpayer uses (as indicated by how he files his tax return) (Rev. Proc. 2002-69). Thus, taxpayers can select whichever treatment they prefer. In separate property states, this determination is based on the facts and circumstances. However, as is the case in separate property states, these rules for reporting trade or business income either as a partnership between the spouses or as a proprietorship do not apply if one spouse is a genuine employee of the other spouse's sole proprietorship.

Electing Large Partnerships

Partnerships with 100 or more partners may be eligible for treatment as "electing large partnerships." Eligible partnerships can reduce the number of items that must be separately stated to partners, simplifying reporting requirements. Qualifying partnerships file Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*. See instructions to Form 1065-B for details. Generally, Form 1065-B must be filed electronically. A hardship waiver of this requirement (see the Form 1065-B instructions) may be requested.

Tax Assessments

The Supreme Court upheld the IRS's right to pursue claims against individual partners in their Chapter 13 bankruptcy cases for partnership employment taxes assessed less than 10 years earlier. The three-year deadline for assessment of tax was met by the assessment against the partnership, and was not dependent on additional separate assessments against each individual partner. [*Galletti*, 93 AFTR 2d 2004-1425 (Sup. Ct. 2004)]

Exclusion From Partnership Treatment

Certain investing and operating agreement partnerships that do not actively conduct a business may choose to be excluded from partnership treatment for federal income tax purposes. (Reg. §1.761-2)

Investing partnership. *A group whose members:*

- 1) Jointly purchase and sell investment property,
- 2) Own the property as co-owners,
- 3) Reserve the right separately to take or dispose of their shares of any property acquired or retained,
- 4) Do not actively conduct business and
- 5) Do not irrevocably authorize another person to purchase, sell or exchange the investment property. A member may delegate someone to act for his/her account for not more than one year.

Operating agreement group. *A group whose members:*

- 1) Participate in joint production, extraction or use of property,
- 2) Own the property as co-owners,
- 3) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted or used and
- 4) Do not jointly sell services or the property produced or extracted, although a member may delegate authority to sell his/her share of the property produced for his/her account for a period not to exceed one year.

Advantages of electing out of partnership status:

- 1) Tax elections are made at the individual level rather than at the partnership level.
- 2) A partnership tax return is not required.
- 3) Members do not have to depend on the partnership to give proper tax treatment to various items.

To make the election, attach a statement to a blank Form 1065 and file by the due date (including extensions) of the partnership tax return. The statement must contain: [Reg. §1.761-2(b)(2)]

- 1) The name and address of the organization,
- 2) The names, addresses and TINs of all members,
- 3) A statement that the organization qualifies as an investing partnership under Regulation Section 1.761-2(a)(2) or as an operating agreement group under Section 1.761-2(a)(3),
- 4) A statement that all members of the organization consent to be excluded from Subchapter K and
- 5) The contact name and address where information may be obtained about the written or oral operating agreement.

Once the election is made, it cannot be revoked without IRS consent unless the organization ceases to qualify. If the organization begins to operate an active business, the election is revoked and the partnership must begin to file Form 1065.

Caution: The election applies only for purposes of determining federal income tax liability. Even with a valid exclusion in place, it is possible for a business entity to be treated as a partnership under other sections of the Code.

Examples:

- A business not taxed as a partnership was an employer for employment tax purposes. [*Cokes*, 91 TC 222 (1988)]
- A business with a valid exclusion in place was treated as a partnership for purposes of limitations on investment tax credits. [*Bryant*, 46 TC 848 (1966)]

PARTNERSHIP INCOME AND EXPENSES

A partnership is a pass-through entity. Income or loss is passed through to partners, who then report the partnership income on their individual tax returns. The partnership itself does not pay income tax.

A partnership computes income from business operations similarly to a sole proprietor. Net profit or loss is allocated among the partners according to the partnership agreement, generally in proportion to ownership interests. Income or loss that is passed through to a partner is referred to as the partner's *distributive share*.

The character of income, gains, losses, deductions or credits included in a partner's distributive share is determined as if the individual partner directly received the income or incurred the expense from the same source from which the partnership received the income or incurred the expense. So, for example, if a late filing penalty is nondeductible when paid by an individual, it retains its nondeductible character when passed through the partnership to the individual partner. [IRC §702(b)]

Each partner pays tax on his or her distributive share of income in the year earned or received (depending on whether the partnership uses the accrual or cash method of accounting), regardless of when the income is distributed. Accordingly, when a partnership distributes cash or property to a partner, the transaction is generally not taxable. See *Partnership Distributions* on Page B-9.

Form 1065, *U.S. Return of Partnership Income*, reports business income, deductions, credits, gains and losses resulting from partnership operations. Form 1065 includes a separate Schedule K-1 for each partner, which shows each partner's distributive share of income, along with certain other separately stated items. The partnership must furnish a copy of Schedule K-1 to each partner by the due date, including extensions, of the partnership return.

An individual reports ordinary income from a partnership on Schedule E of Form 1040. Other items of income or loss are reported on the appropriate forms or schedules. For example, capital gains shown on a partner's K-1 are reported on Schedule D of a partner's Form 1040.