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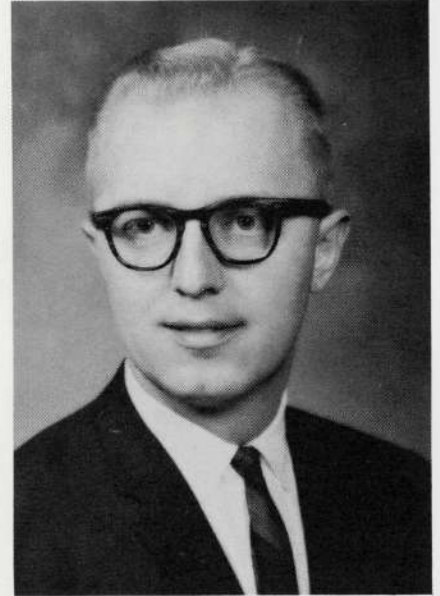
A brief look at Tax Considerations of Partnerships

by David J. Vander Broek



DAVID J. VANDER BROEK, supervisor in our Detroit office, joined TRB&S in 1957 after graduating from Michigan State University with a B.A. degree.

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A native of Michigan, he is married and the father of four children.

This article is not intended to thoroughly explore all considerations for the partnership form of operations or the full implication of federal taxation of partnerships. Rather, its purpose is to provide general knowledge of partnership taxation and to highlight certain partnership tax problems and planning areas.

The partnership form of business operation is one of the dominant forms of business organization existing in our country today. Laws governing these operations vary among the states, although the general tendency at present is toward the adoption of the Uniform Partnership Act.

Federal taxation of partnership income is based upon passing annual partnership profits or losses through to the individual partners for inclusion in their respective individual income tax returns. Although this generality is true, specific partnership transactions can present a variety of complex income tax problems which should be carefully explored (or deplored, as is often the case) by competent tax personnel. This article, however, leaves the details of partnership tax complexities to tax personnel and concentrates on a more general review of partnership tax considerations.

Choice of Taxable Operation

When two or more persons join their capital, property, or services to carry on a business for profit, they first must decide which business entity to use for their operations. The nontax aspects of this decision, such as capital requirements, nature, size, and duration of the business, may automatically formulate this decision for them. Often, however, the federal income tax consequences in the small-to-medium size business operations are equally important factors for owners to consider in arriving at their choice of business entity.

In addition to normal partnership arrangements, syndi-

cates, groups, pools, joint ventures, and other forms of dual ownership, unincorporated organizations will normally be taxed as partnerships. Accordingly, the choice of taxation on the results of multiowned business operations is generally limited to partnership or corporate taxation.

All items of tax significance with respect to a partnership's operations are determined and reported to the government as an accounting entity. However, as the partnership is not a *taxable* entity, it annually allocates its operational results among its partners in agreed proportions for inclusion in their tax returns for the year in which, or with which, the taxable year of the partnership ends. Current normal partnership distributions of cash to the partners of these annual operating results generally bear no incident of taxation.

Corporations, however, are both an accounting and a taxable entity. Accordingly, for a corporate stockholder to receive distributions of income from the results of corporate operations, such income must generally first be taxed at the corporate level and again at the time it is distributed to the stockholder as a dividend.

In comparing the total tax costs of these two forms of operation, realistic estimates of anticipated income, growth, risk, duration, and tax brackets of individual owners must first be determined. With this information, it is then possible to arithmetically calculate and compare the tax costs to the owners of each form of business enterprise.

Additional items for consideration in making a choice of business entity would include the possibility of (1) bypassing double taxation through annual *reasonable* salary payments to active corporate stockholder employees; (2) the after tax potential to stockholder-employees of various deferred compensation plans (pension, profit-sharing, insurance, etc.) available to partners only through the Self-Employed Individuals Tax Retirement Act; (3) corporate penalty surtaxes upon personal holding companies and improper accumulations of surplus; and (4) treatment of capital gains and losses, additional first-year depreciation, and other items which pass annually for taxation to partners but which are retained at the corporate level for taxation.

Existing business entities should also be reviewed when a combination of events has materially altered the original factors considered in establishing the form of enterprise. One such event could be the passage of the Revenue Act of 1964 with its reduction of individual and corporate tax rates, provisions for income averaging, and personal holding company changes. The need for constant review in this area for business enterprises which do not have obvious reasons for their existing form of business operations seems apparent.

This section would be incomplete without briefly pointing out, for federal income tax purposes, the existence of elections which permit certain small business corporations to bypass taxation on the corporate level by directly allocating to stockholders the annual income or loss of the corporation. Conversely, certain unincorporated business enterprises can elect to be taxed as corporations, rather than having their operating results taxed to the individual owners or partners.

Incidences of enterprises enjoying these optional federal income tax elections are not numerous as these elections are conditioned upon many events. However, they do present interesting possibilities for tax savings under the proper circumstances. One such possibility could be a partnership organization to initially pass through to partners losses during early periods of operations, followed by an election to be taxed as a corporation in later periods of substantial profits or increased capital retention needs of the business.

In summary, it must be remembered that the owners' enthusiasm for their enterprise, including the glamour of incorporation, may quickly fade if their choice of taxing entity has not been formulated with the proper evaluation of available information. Presumably, as much can be said for the thoughts of their professional advisors.

Starting the Partnership

Having determined that their business enterprise will be operated as a partnership, the partners should then agree upon each partner's distributive share of all partnership items which will annually be allocated to them. For many legitimate business reasons, certain items of partnership income, deductions, or credits should be divided among the partners in one manner, while other items should receive different allocations. Or, to state it differently, allocable partnership items should be evenly distributed between *all* partners only when each has contributed equal amounts of cash and services to the operation.

It is important to incorporate these special distributive share arrangements into the partnership agreement; without such provision all items would be shared by the partners in relation to their general share of partnership taxable income or loss.

The need for such special allocation agreements between partners can best be illustrated by contributed property. A partner generally realizes no gain or loss on his contribution of property to a partnership in exchange

for his interest in the partnership. The partnership's tax basis for the contributed property is the same as that for the property in the hands of the contributing partner.

> Assume A and B form a partnership with equal 50% interests in partnership capital and profits. A contributes $10,000 in cash while B contributes property with a fair market value of $10,000, but with a basis of $5,000 to B. Assume further that the property is sold by the partnership for $10,000 cash. At such time, the partnership has realized a taxable gain of $5,000 (difference between sales price of $10,000 and B's $5,000 basis for the property at the time contributed to the partnership). Although A's economic interest in all partnership assets is still represented by his original $10,000 contribution, he will currently be taxed on his $2,500 share of partnership profit on the transaction, unless the full profit is taxed to B by specific provisions of the partnership agreement.

Although the partnership agreement can simply be an oral understanding evidenced by the conduct of the partners and the recording of partnership transactions, it is evident that a written agreement is preferable. A properly written legal agreement not only documents all special partnership allocations but, among other things, generally provides for all type partnership transfers of interest and the termination of the partnership. The partnership agreement may be modified (orally or in writing) with respect to a taxable year at any time prior to and including the date prescribed by law (excluding extensions of time) for the filing of the partnership return.

A new partnership must also make elections which affect its accounting computations. These would include elections as to methods of accounting and as to depreciation, bad debt, and intangible drilling policies.

A partnership may elect the accrual method of accounting even though all its partners are on a cash basis. However, in general, it must adopt the same taxable year as that of all its principal partners (those with 5% or more interest in partnership profits or capital) or a calendar year if all its principal partners are not on the same taxable year.

Annual Operating Results

As previously mentioned, partnerships do not pay income taxes. They must, however, file income tax returns setting forth the results of their operations for the year and the allocation of these results among the various partners. In arriving at net ordinary income (or loss) which will be allocated among the partners, all special items of income, deductions, and credits must *first* be segregated and allocated separately. This separation is necessary because of the host of limitations and special computations relating to capital gains and losses, dividends, contributions, foreign taxes and other credits. Since the special partnership items passed on to the partners maintain their same characteristics in the hands of the partners, the partners must be informed by the partnership of their shares of these special items as well as their shares of ordinary income or loss.

In arriving at allocable ordinary income or loss, the partnership must also eliminate nontaxable items (tax-free interest, political contributions, nonbusiness expenses) and guaranteed payments. The latter is most often simply annual guaranteed amounts due certain partners for their services or capital utilized by the partnership regardless of the firm's profit or loss for the year. Accordingly, its payment is taxable to the applicable partners and deductible by the partnership as if made to third parties.

Although it is clear that the amount (as opposed to character) of special items subject to limitations or special computations which a partner reports on his return is determined at his own level, the quantity of partnership mechanics needed to compute these special items varies. This is illustrated by examing the partnership mechanics relating to the additional 20% first-year depreciation allowance and the investment credit limitation on purchases of used property.

The additional first-year depreciation allowance on purchases of qualified personal property must be elected by the partnership. The amount of such allowance must be determined separately for each partner and may equal a maximum of 20% of such property *allocable* to each partner. The portion allocable to each partner is further limited to $10,000 or $20,000, depending upon his marital status and whether he files a separate or joint tax return. Accordingly, the partnership must schedule the qualifying property, compute the allocable interest of each partner in such property, apply the maximum limitation applicable to each partner, and then calculate each partner's dollar amount. This last information is passed on to the individual partners for inclusion in their returns.

In contrast, the credit against taxable income for investment in *used* tangible personal property by a partnership is computed upon a maximum of $50,000 of annual purchases of such property by the partnership. The partnership simply selects the applicable $50,000 or less of used property, determines each partner's share of such property, and passes the information along to the partners.

Basis of Partnership Interests

A partner's basis in partnership capital and profits is generally a capital asset and should be carefully maintained and documented for future needs, as required for any capital asset. As will be noted below, the adjusted basis of a partner's interest in the partnership at any particular time will not necessarily be determined by reference to the partnership records which reflect his capital or equity account for book purposes.

When entering a partnership, the partner's basis is normally represented by his cash contributions and the basis to him of other property contributed. The fair market value at the time of contribution of property (other than cash) does not affect his basis even though recorded at the fair market value on the books of the partnership. Should a partner initially contribute nothing to the partnership but services to be rendered in the future, his basis is zero until the end of the year in which such services are rendered.

In general, this initial basis is increased by the partner's share of partnership taxable and nontaxable income and any additional property contributions by him. It is decreased by his share of partnership losses (deductible and nondeductible) and by draws or distributions of property to him by the partnership. In no event, however, can his basis be reduced below zero.

A partner's basis for his partnership interest at a particular time must also be increased by his share of partnership liabilities since this is considered, for basis determination purposes, a contribution of cash to the partnership. Correspondingly, any decrease in a partner's share of partnership liabilities will be considered a distribution of cash to him by the partnership. This factor combined with partnership losses can present a planning area, as will be subsequently noted.

A partner is limited in deducting his share of annual partnership losses on his individual tax return to the extent of the adjusted basis of his partnership interest determined as of the end of such taxable year and excluding his loss for such year. Any such loss disallowed in one year because of a zero basis for his partnership interest can be carried over (without time limitation) and deducted on subsequent years' returns when the basis for his partnership interest has been sufficiently increased. Accordingly, a partner facing potential allocable partnership losses in excess of his partnership basis in any particular year could secure such losses for use in his personal return by increasing his basis in the partnership prior to year-end. This could be accomplished by his additional contributions of capital or by the partnership incurring additional liabilities which would be allocable to him. Conversely, a partner wishing to defer his reportable losses to the subsequent year could force the basis for his partnership interest down to zero prior to year-end by current partnership distributions of cash to him and thereby effectively carry over his share of reportable partnership losses to the subsequent year.

An alternative rule exists for determining a partner's basis for partnership interest when it is impracticable (or impossible) to apply the above-noted general rules. Simply stated, it allows determination of a partner's basis for his interest in a partnership by reference to his share of the adjusted basis of partnership property which would be distributed to him upon termination of the partnership. In practice, such basis would presumably be the partner's capital account on the books of the partnership. This rule applies only to situations where the partnership has been in existence for a number of years and the information needed to correctly determine a partner's basis is totally lacking or in a hopeless state of confusion. Unfortunately, this situation often exists.

Partner and Partnership Transactions

Ordinarily, transactions between a partner and the partnership, entered into by the partner in a capacity other than that of a partner, will be considered as between the partnership and a third party. Therefore, a partner can in good faith buy or sell property, make loans to, and render services to the partnership without incurring detrimental federal income tax effects. Exceptions to this rule (1) disallow *losses* on sale or exchange of property (other than a partnership interest) between a partnership and a partner whose interest (direct or indirect) in capital *or* profits is more than 50%; (2) disallow losses on sale or exchange of property between two partnerships where the same persons own more than 50% of the capital or profit interest of each partnership; (3) deny capital gain treatment on certain transfers between a partnership and partner owning more than an 80% interest in capital or profits, or between two partnerships in which the same persons own more than 80% of such interests; and (4) require inclusion in the return of a partner on the cash basis of his accrued partner's guaranteed payments in the same year within which, or with which, ends the partnership year in which the payments were accrued and deducted.

Distributions to partners and transfers of their interests in the partnership can be accomplished in many ways. Each method can produce different income tax results to

the partners concerned. The following comments reflect only broad guidelines for these transactions and do not attempt to explore the inherent planning possibilities.

Nonliquidating Distributions

As mentioned previously, distributions of cash to a partner are ordinarily nontaxable events which simply reduce his partnership basis. However, if the cash distributions *exceed* his basis, such excess will normally be taxable to him as capital gain. Distributions of property other than cash do not result in gain to the distributee partner but simply reduce the basis for his partnership interest. The amount of this reduction of basis is equal to the partnership's adjusted basis for such property immediately prior to the distribution. It is also the basis of the property in the hands of the distributee partner. Should the basis of the distributed noncash partnership property *exceed* the basis of the distributee's interest in the partnership, special rules require the allocation of this lower basis to all the distributed property. Special attention must be given in such an allocation to unrealized receivables and certain inventory items which, upon ultimate disposal by the distributee partner, will result in the recognition to him of ordinary income.

The partnership recognizes no gain or loss on these distributions but may, in certain instances, elect to adjust the basis of its remaining property to offset the tax effect of the distribution on the distributee partner.

Liquidating Distributions

Similar rules apply to the complete liquidation of a partner's interest in a partnership. In addition, it is possible to have a loss on a complete liquidation if (1) the liquidating partner receives *only* money, unrealized receivables, and certain inventory items; and (2) the basis for his partnership interest being liquidated *exceeds* the money *and* the partnership's adjusted basis for the unrealized receivables and inventory distributed to him. Such excess basis is reportable as a capital loss by the partner in the year of liquidation.

Termination of Partnership Interest

When a partner's interest in a partnership is terminated by sale, withdrawal, or death, the economic effect is similar to that regarding complete liquidation noted above. The normal tax effects can be generalized as follows:

A. The terminated partner's share of actual partnership income or loss for the current year through the date of termination of his interest is taxable to him.

B. Payments for his interest in partnership capital assets result in capital gain or loss.

C. Payments for his interest in partnership unrealized receivables or certain inventory items generally result in ordinary income.

However, the tax effects of the termination of a partner's interest on a *sale* of his interest may differ in several ways from those resulting from receiving withdrawal payments from the partnership. Primarily, these differences relate to the year in which the terminated partner must include the payments for his partnership interest in his own return and the character (ordinary or capital gain) of the income to be reported.

The partnership (and thus the remaining partners) will also be affected by the form of the transaction. For instance, on a withdrawal, the partnership may receive a current deduction on account of payments to the withdrawing partner for unrealized receivables. On a sale, however, the partnership may merely be entitled to increase its basis for these unrealized receivables (with the proper election) and thereby receive only a future tax benefit for such payment.

Termination of Partnership

Neither provisions of local law nor provisions in partnership agreements for the addition of new partners or withdrawal of partners will terminate an existing partnership for federal income tax purposes. A termination will occur for tax purposes *only* (1) when the partnership ceases to conduct any portion of its business as a partnership or (2) when within any 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital *and* profits.

Professional Responsibilities to Partnerships

The average partnership does not usually compare in size with the average corporation. With smaller businesses, there is often a tendency to ignore professional assistance in the belief that it is either too costly or not necessary. Too often this belief persists as the business grows and prospers, regardless of an increasing need for professional assistance and the status of financial position. As originally stated, this article was not intended to develop "partnership tax experts." It was, however, intended to increase the reader's general familiarity with partnership tax problems which, hopefully, will ultimately benefit our clients.

GENERAL FOOTNOTE

Specific references for items included in this article are contained in Sections 701 - 771, Internal Revenue Code (1954) and the Treasury Department Regulations thereunder.