Module 3.5: Partnerships & Qualified Joint Ventures

As we previously discussed, partnerships are one of the most popular legal formats because of the flexibility they offer all of the partners. And because of this flexibility, this module has turned out to be the longest, so hang in there. Let me start by giving you some examples:

Although S-corporations and partnerships are both passthrough entities, partnerships have the unique availability of *special allocations* to their partners. For example, a partnership agreement may allocate all of the depreciation deductions to one partner subject to limitations. Or, a partnership agreement may specify that the partners may share capital, profits, and losses in different ratios regardless of their investment in the partnership. In other words, the sharing of profits does not have to coincide with the sharing of losses.

Partnership agreements can be written to reflect whatever economic sharing arrangement and risk sharing arrangement the parties wish to execute. For example, Partner A, who has skills, goes into business with Partner B, who has capital. Partner B contributes $100,000 in cash. They agree to split the business profits 20/80 until B recovers his $100,000; and then future profits are split 50/50. These special allocations permit partners to assume different levels of risk and to set the timing of income the way it seems fair to them.

Of course, such flexibility comes with strings attached. Even though partners are able to allocate profit or loss between themselves, one partner can't pay the taxes for another partner. A partner who is economically enriched by an item of partnership income or gain is required to shoulder the tax burden associated with it. Likewise, a partner who is economically hurt by an item of partnership loss has to be allocated the tax benefit of the loss.

Considering all of the basis and allocation rules, and the fact that there is no limit on the number of partners, partnerships can become quite complex, but for certain situations they can bring together people who have vastly different things to offer and give them a viable and fair format to do business.

Make sure that the special allocations you make are really necessary to bring the assets you need into the business. This is because all of these allocations have to be tracked as part of your tax return.

What I'm about to discuss with you is probably just about 20% of all the tax rules involving partnerships and all the various way they can be taxed as the partnership gains partners, adds partners, loses partners, or have partners retire. My hope is by knowing the following, you will be able to keep the proper records required and understand the results any changes to the partnership will produce.

Partnerships file Form 1065, *U.S. Return of Partnership Income*, each year. It is due two months and 15 days after the close of the calendar or fiscal year. For a calendar year partnership, this would be March 15th. The partnership then creates a Form K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, reporting each partners share of income and deductions. The information on the K-1 will be entered on each partner's personal tax return and the taxes are paid at the partner level. A partnership can obtain an automatic five-month extension to file the return if necessary by filing Form 7004, but this creates a problem for the partners because they have to also file an extension to do their personal return or file an amended return when they receive the Form K-1 from the partnership.

The Form 1065 is know as an Information return, since income taxes are not paid at the partnership level. The 1065 and a copy of all of the K-1s are sent to the IRS, which is used to crosscheck if people are entering this information on their personal returns.

The 1065 is called a pass-through entity because the tax liability passes down to the partner. These tax liabilities pass down to the partner in the way they are taxed at the personal level. For instance, interest income is passed down and added to your other interest income. Dividend income is added to any other dividend income. Profits from stock sales are added to your other capital gains. Rental income or ordinary income is added to your other Schedule E income. And so forth.

It is not the purpose of this module to teach you how to do a partnership tax return, because they can become very complex. What we are going to do is review all of the things that you should be aware of or need to keep track of to prevent problems down the line. Such as:

Form 1065 has to be filed each year the partnership is in existence, even if you have all zeros on it, or you will have to pay a hefty fine for non-filing. Should you wish to end the partnership, then you need to check-mark 'Final Return' on the Form 1065 sent to the IRS and on the K-1 Forms sent to each partner. When the IRS sees that check-mark, they will no longer expect a return.

Tax Year

The partnership is required to used the tax year used by the majority of its partners or members, which is typically a calendar year. This is called majority year. If there is no majority year, then the partnership's tax year is that tax year of all of its principle partners. Principle partners are those with interest of more than 5%. This usually only happens when the partnership is owned by other partnerships or corporations. While you can request a different tax year, the calculations are complicated and you have to pay a fee and upfront taxes for the IRS to consider it.

Partner Payments

Payments to partners are ***never*** treated as salary or wages since partners are not employees. This means that while a partnership can hire W-2 employees, partners can't be W-2 employees or independent contractors of the partnership themselves. Although partners receive cash throughout the year, when it comes time to record it on their taxes, the income in broken down into three basis types:

- Guaranteed Payments
- Partner Draws
- Separately Stated Items

One of the items that can be included in a partnership agreement is Guaranteed Payments. This occurs when the partnership agrees to pay one or more of the partners a certain amount of money, regardless of whether the partnership makes a profit or not. This often happens when the partnership needs to bring in a person with a particular skill set and they will only join the partnership if they are guaranteed a certain amount of income. Guaranteed Payments are a line item deduction to the partnership. To the partner receiving guaranteed payments, they are considered self-employment income subject to self-employment tax like the profits made by a sole proprietor. Guaranteed payments to retired partners or estates of deceased partners are treated the same way.

Partners Draws are simply requests to receive a portion of the profits of the partnership. This is also much like the sole proprietor moving business profits from their business account to their personal accounts. At the end of the year, the amount distributed is recorded on the K-1 (1065) that the partnership gives to each partner. How much tax and what kind of tax is owed depends on whether you are a general partner or a limited partner as we discussed in Module 1.3. The general partner pays regular tax and self-employment tax on their share of profits (which includes the draws) and the limited partner just pays capital gains on their investment. It should be noted that the partner pays taxes on the entire amount of profit their percentage of the partnership makes, even if they have not drawn it out yet.

Separately Stated Items refer to partnership income like interest received, dividends received, or capital gains from partnership investments . As noted above, interest income is passed down and added to your other interest income. Dividend income is added to any other dividends. Profits from stock sales are added to your other capital gains. Charitable contributions flow through to the Schedule A on the personal return. To look at it another way, all of these items have a separate way they are entered on the personal 1040 tax return instead of just being added to wages.

Remember that if you are a general partner or receive guaranteed payments, you need to send in estimated taxes to the IRS and/or state tax authorities. This is done in the same way we discussed in our module on sole proprietors.

Schedule K and Form K-1 (Form 1065)

Schedule K, which appears on page 4 of Form 1065, is used to report:

- Ordinary income or loss
- All separately stated items of income, deductions, gains or losses, and credits that are passed through to the partners

Schedule K reports the entire amount of these items. The amounts from Schedule K are then allocated amount the partners on the Schedule K-1s to permit the partners to report their respective shares of those items on their own income tax returns.

Income is broken down into the various categories so it can be entered in the proper area of your personal return. They include:

- Ordinary income or loss
- Rental income or loss
- Guaranteed payments (including health insurance coverage)
- Interest income
- Dividend income
- Royalties
- Short-term capital gains
- Long-term capital gains

There are also deductions that are separately stated on the Schedule K. These include:

- Section 179 deductions (discussed in the next module)
- Charitable deductions
- Investment interest expense
- Credits and credit recaptures (such as employment, low-income housing credits and a whole series of business credits available to small businesses; defined as gross receipts of less than one million and no more than 30 employees)
- Foreign Transactions

The Schedule K also contains information to tell each partner more about how the partnership is doing, such as how much of the income is subject to self-employment tax, how much of the income was for farming activities, and how many of the expenses were non-deductible.

Now, a lot of these categories have their own set of rules of how they affect the partnership and partners, many depending on the type of business the partnership is engaged in. For instance, here is a stipulation concerning first year expenses:

"Even if the first-year expense deductions cannot be fully utilized, the partner's adjusted basis in the partnership interest is reduced by the partner's distributive share of the expense deduction even though the partner is prohibited from deducting all or a portion of such expenses because of the dollar limitation"

That's enough to make yours eyes glaze over, but it is also why you need a seasoned tax professional that specializes in business returns to properly navigate all of the rules and *exceptions* to the rules. Mistakes can be costly to fix, if they are allowed to be fixed at all. As I've stated before, my aim is to make you aware of all the moving parts so can properly discuss these items with a professional.

The Schedule K-1 parallels the Schedule K, in that it shows the partner's share of the various items discussed in Schedule K. In general, Schedule K-1 is completed by applying the partner's share of the business to the amounts on the Schedule K. The K-1 also indicates where on the personal return these items should be entered.

You will recall that in our previous discussions on partnerships that special allocations can be made if your create a partnership agreement. The K-1 is where those special allocations are applied. This is why when I have a new client that owns a partnership, one of the first things I ask for is a copy of their partnership agreement so that I can properly allocate things on their K-1.

If a partner joins the partnership in mid-year or a partner's profit and loss ratio is modified during the year to reflect additional cash contributions by him or her or other partners, special allocations must also be computed to account for this.

A Schedule K-1 is required for each person who was a partner at any time during the year. For instance, if the partnership has 50 partners at any time throughout the year, there must be 50 K-1s attached to the partnership return.

For each failure to furnish Schedule K-1 to a partner when due and each failure to include on Schedule K-1 all the information required to be shown (or including incorrect information), **a $260 penalty may be imposed for each Schedule K-1** for which a failure occurs. **The maximum penalty is $3,178,500 for all such failures during a calendar year**.

On top of that, A penalty is assessed against the partnership if it is required to file a partnership return and it (a) fails to file the return by the due date, including extensions or (b) files a return that fails to show all the information required, unless such failure is due to reasonable cause. **The penalty is $195 for each month or part of a month (for a maximum of 12 months) the return has not been filed**, *multiplied* by the total number of persons who were partners in the partnership during any part of the partnership's tax year for which the return is due.

Partnership Basis

In the last module, we discussed what basis is, and how it increases or decreases. So, if you haven't watched Module 3.4 yet, please go back and watch that first. In this module, I would like to go through some of the ways those principles are applied to partnerships.

Each partner needs to determine his or her basis in the partnership interest and they are responsible for keeping track of it. Basis is important for a couple of reasons. When a partner sells the partner's partnership interest, that partner needs to know the basis to determine whether they made or lost money on the transaction. The other reason is that losses from the partnership cannot exceed the partner's basis in that partnership. Losses in excess of basis must be carried forward to future years until there is enough additional basis to subtract it from. There has been a lot of cheating when it comes to the excess of basis rule, so keeping track of basis has become a big red flag with the IRS in audits. Don't ignore this part.

The basis in a partner's interest in the partnership is increased by:

- Partner's share of the partnership profits
- Partner's share of tax-exempt income (such as life insurance proceeds)
- Additional cash or property contributions
- Agreeing to be personally liable for some of the partnership's debt

The basis in a partner's interest in the partnership is decreased, but not below zero, by:

- Partner's share of partnership losses, including capital losses
- Partner's share of non-deductible expenses
- Distributions of cash - If cash distributions exceed a partner's basis, the excess is treated as a gain and is taxable income to the partner. This is because basis can never go below zero, so anything below that is considered income.
- Partner's share of Section 179 deductions
- Partner's share of charitable contributions
- Partner's share of foreign tax credits
- Property distributions to the partner - If the property distributions exceeds the partners basis, the excess reduces the basis in the property received.

- By a decrease in his or her share of partnership liabilities. Again, if the decrease in liabilities exceeds the partner's basis at year end, taxable gain will result, because a partner can never have a negative basis.

Outside Basis and Inside Basis

The value of what the partner contributes to the partnership is known as the outside basis. This is because it is the value of the property in the hands of the partner that was contributed. The inside basis is the value of the property in the hands of the partnership. When a partner contributes cash, then both are the same. However, when a partner contributes property, then they can differ - which is why each partner has to keep track of their outside basis. Let me give you an example to make it a little clearer.

> Adams, one of two equal partners, contributes $20,000 cash. Brad, the other partner, contributes unimproved real property worth $20,000, but originally cost him $10,000. Brad's outside basis in the partnership is $10,000. The partnership's basis (inside basis) would be $20,000, the FMV, because the partnership would likely have to pay the higher value to purchase the property. This is one of the reasons why the partnership's capital accounts do not necessarily equal the sum of the partner's outside basis. So when you see the capital account on a K-1, that is not necessarily the true basis of the partner - but what their contributions are worth to the partnership.

While there is no need to know every little rule about partnership basis, there are a few situations we should cover so you don't get blind-sided.

Acquiring a Partnership Interest in Exchange for Services

Often a potential partner doesn't have much money, but they do have a skill that that the partnership needs. So, they trade their services for a share of the partnership, often without realizing the tax consequences of this arrangement. The value of the contribution to the partnership is the fair market value (FMV) of the services at the time of transfer. This is treated as a Guaranteed Payment to the partner providing the services, which will be reflected on their K-1. This means the person contributing the services will owe income tax and self-employment tax on the FMV of the services when they do their personal return. The amount they pay taxes on becomes their outside basis in the partnership.

Gifts

When a partnership interest is received as a gift, the person receiving the gift will have a beginning basis in the partnership equal to the basis of the partner who gave them the partnership interest as a gift. Whether the donor's basis or FMV is used are the same rules we discussed in the previous module.

Inheritance

In the last module, we discussed the basis of property that is inherited has a stepped-up basis. So, in the case of an inherited partnership interest, the general rule is that the basis in the partnership for the beneficiary is the FMV of the partnership interest on the decedent's date of death. A section 754 election can be made to allow the partnership to adjust assets of the beneficiary partner to match the partnership basis to bring the inside and outside basis into equality again, if desired.

Basis of a Partnership Interest Purchased from a Partner

The outside basis to a new partner who buys an existing partner's partnership interest is the price they pay to acquire the share. Again, if part of what they pay is property, their basis and not the FMV is used.

End of the Year Considerations

At the end of each year, you need to update your outside basis with any additional contributions you made to the partnership and the items on the Schedule K-1 that you receive. Most modern professional tax software actually have basis worksheets that can be printed out and given to the partners to help them reconcile the data. Working with my clients, I always asked if they made any additional contributions to the partnership and if they took any distributions. I then add this to the basis worksheet, the current year information is added, and I print them out the worksheet with their outside basis figured. This worksheet is also found in the *Partner's Instructions for Schedule K-1 (Form 1065)* in the IRS manual if you are doing your own tax returns.

Sale of a Partnership Interest

When a partner sells his or her interest, any gain or loss is generally treated as a capital gain or loss. That said, there are special rules if the sale includes unrealized receivables, inventory items, corporate partners that contributed stock, the sale of a multi-member LLC to a single buyer or the sale of a single-member LLC to multiple owners, or a liquidating distribution on the retirement or death of a partner.

There is no way that I am going over all of these different situations or those upon termination of a partnership. But there is something that you need to know that could accidentally terminate your partnership without you knowing it.

There is a federal rule that states if 50% or more of the ownership of both partnership capital (inside basis) and profits turns over by sale or exchange within a 12-month period - the partnership automatically dissolves and you would have to create a new partnership to continue.

Since gifts, retirement or death are not considered sales at the federal level, the partnership will not terminate in those situations.

However, you also need to be aware that some states have rules that when a partner leaves for retirement or death, the partnership dissolves. So it is best practice to ask your tax preparer about the statutes in your state that affect changes in ownership.

Qualified Joint Ventures

I want to end with one final consideration regarding businesses owned by married couples.

Prior to 2007, an unincorporated business (such as a sole proprietorship) owned by a married couple was classified as a partnership for federal tax purposes. The Small Business and Work Opportunity Tax Act of 2007 provided for a “qualified joint venture.”

A qualified joint venture (QJV) is a trade or business whose only members are a married couple. They both must materially participate in the business, and they must file a personal joint return to qualify. If they meet these requirements, they can elect to not be treated as a partnership (with all of the extra legal and paperwork requirements) by simply filing a Schedule C for each spouse. Since each spouse will have their own Schedule C reporting their share of the income and expenses, they will also each have their own Schedule SE for their share of social security and medicare.

The other restriction is: If the business is formed as an LLP or a LLC, the Qualified Joint Venture election may **not** be made - except in community property states.

Before we discuss the tax implications for corporations, we will be discussing depreciation in the next module. See you there.

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