

20 Partnerships and LLCs

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Electronic Filing

Mandatory electronic filing. Certain partnerships with more than 100 partners are required to file Form 1065 and related documents electronically. A waiver of the mandatory electronic filing requirement may be granted before the return is filed, if hardship is shown and will be based on all facts and circumstances.

Waiver request. Guidance on waivers for partnerships unable to meet e-file requirements can be found at www.irs.gov/Tax-Professionals/e-File-Providers-&Partners/Guidance-on-Waivers-for-Partnerships-Unable-to-Meet-e-File-Requirements.

- IRS e-Help Desk 866-255-0654.
- See *Electronic Filing*, page 18-2.

■ New for 2015 ■

- **Filing deadline.** For tax years beginning after December 31, 2015, the due date for a partnership return has changed. See *Filing Deadline*, below.
- **Increased penalty.** The penalty for failure to furnish Schedule K-1 to a partner when due has increased from \$100 to \$250 for each failure. See *Penalties*, page 20-3.

Common Elections

- Election by spouses to be treated as a qualified joint venture instead of a partnership, page 20-4.
- Election to be treated as an electing large partnership, page 20-3.
- Election out of partnership treatment by eligible investing partnerships or operating agreement groups, page 20-4.
- Election to capitalize and amortize start-up costs and organizational costs, page 20-6.
- Election to adjust basis of partnership property under IRC Section 754, page 20-11.

Filing Requirements

Every partnership that engages in a trade or business, or has gross income, must file an information return on Form 1065, *U.S. Return of Partnership Income*, showing its income, deductions, and other required information.

A partnership that neither receives income nor incurs any expenditures treated as deductions or credits for federal income tax purposes is not required to file Form 1065 for that year.

Entities formed as Limited Liability Companies (LLCs) that are classified as partnerships for federal income tax purposes have the same filing requirements as domestic partnerships. See *Limited Liability Companies (LLCs)*, page 20-14.

Business Activity Codes

See *Principal Business Activity Codes for Corporations and Partnerships*, page 24-2.

Note: The IRS periodically revises this list. Check each year for updates.

Filing Deadline

Form 1065, U.S. Return of Partnership Income.

Tax years beginning on or before December 31, 2015. The filing deadline for Form 1065, U.S. Return of Partnership Income, is the 15th day of the fourth month after the end of the partnership's tax year (April 15 for a calendar year partnership).

Tax years beginning after December 31, 2015. The due date to file Form 1065 is changed to the 15th day of the third month after the end of the partnership's tax year (March 15 for a calendar year partnership).

Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc. The partnership is required to provide Schedule K-1 to each partner on or before the day on which the partnership return is required to be filed (including extensions).

Extensions

Automatic five-month extension of time to file Form 1065. Form 7004, *Application for Automatic Extension of Time to File Certain Business Income Tax, Information, and Other Returns*, is used by partnerships to extend the filing deadline for five months. No signature is required. For details on filing the form electronically, visit www.irs.gov/efile. For mailing addresses, see page 25-1.

Where to Report Income and Expenses (Form 1065)

Item	Description	Where to Report on Form 1065
Capital gains and losses	Gains or losses from assets held for investment by the partnership.	Compute on Form 8949 and carry to Schedule D, Form 1065. Gains or losses flow through on Schedules K and K-1, Form 1065.
Charitable contributions	Partnership contributions to qualified charitable organizations.	Flows through to partners on line 13a, Schedule K, and box 13, Schedule K-1, codes A through G.
Cost of goods sold	Amounts paid for raw materials and merchandise less ending inventory.	Computed on Form 1125-A. Deducted from partnership income on line 2, Form 1065.
Dependent care benefits	Amount paid on behalf of partners for dependent care benefits.	Line 13d, Schedule K, and box 13, Schedule K-1, Code O.
Depreciation	Assets purchased and placed in service by the partnership.	Form 4562. Depreciation is deducted from partnership income on line 16, Form 1065.
	Assets contributed by partners.	If FMV is different from the contributing partner's adjusted basis, any adjustments are reported to the partners on line 11, Schedule K, and box 11, Schedule K-1, Code F.
Domestic production activities deduction	IRC section 199 deduction the partnership chooses to pass through to the partners.	Line 13d, Schedule K, and box 13, Schedule K-1, Code T.
Educational assistance benefits	Amounts paid on behalf of partners for educational benefits.	Line 13d, Schedule K, and box 13, Schedule K-1, Code N.
Expenses from trade or business activities	Does not include capitalized expenses, expenses incurred in nonbusiness rental activities, or cost of goods sold.	Page 1, Form 1065.
Farm profit or loss	Net profit or loss from farming other than farm rental activities.	Schedule F, Form 1040. Net profit or loss is carried to line 5, Form 1065.
Guaranteed payments	Payments to a partner that are not determined by profits. Includes amounts paid for health care for a partner, spouse, or dependent.	Line 10, Form 1065; also on line 4, Schedules K, and box 4, Schedule K-1.
Health insurance	Premiums paid for partnership employees.	Line 19, Form 1065, unless included in cost of goods sold on Form 1125-A.
	Premiums paid for partner, spouse, or dependent.	Report as a guaranteed payment on line 10, Form 1065, and line 13d, Schedule K, and box 13, Schedule K-1, Code M.
Income from trade or business activities	Does not include rental income, interest, dividends, or other portfolio income.	Page 1, Form 1065.
Investment expenses	For purposes of computing deductible investment interest for partners.	Line 20b, Schedule K, and box 20, Schedule K-1, Code B.
Investment income	For purposes of computing deductible investment interest for partners.	Line 20a, Schedule K, and box 20, Schedule K-1, Code A.
Investment interest expense	Interest allocable to debt on property held for investment by the partnership.	Line 13b, Schedule K, and box 13, Schedule K-1, Code H.
Meals and entertainment	Meals and entertainment expenses subject to the 50% limit under IRC section 274(n).	Allowable deduction is reported on line 20, Form 1065. Nondeductible portion is reported on line 18c, Schedule K and box 18, Schedule K-1, Code C.
Organization costs	Amounts attributable to creation of the partnership and chargeable to a capital account.	May be deducted, amortized, or capitalized. See <i>Start-Up Costs and Organizational Costs</i> , page 20-6.
Rental income and expenses	Rental real estate that is not a trade or business activity.	Form 8825; flows to line 2, Schedule K, and box 2, Schedule K-1.
	Rental activity other than rental real estate or rental as a trade or business activity.	Line 3, Schedules K and K-1.
Retirement plan contributions	Contributions to employees' retirement plans.	Line 18, Form 1065.
	Contributions made on behalf of partners.	Line 13d, Schedule K, and box 13, Schedule K-1, Code R.
Sales of assets	Assets used in trade or business activities.	Form 4797. Ordinary income from trade or business flows to line 6, Form 1065. Capital gain carried to Schedules K and K-1, Form 1065. See <i>Special disclosure for certain disposals of business property</i> , page 20-7, if Section 179 was claimed.
	Assets used in rental activities.	Form 4797. Ordinary gains and losses are reported on Form 8825 or line 3, Schedule K, and box 3, Schedule K-1.
Section 179 expense	Expense for assets placed in service during the tax year.	Form 4562. Line 12, Schedule K, and box 12, Schedule K-1.
Start-up costs	Expenses paid or incurred before the start of business operations. Must be for items that would be deductible by an ongoing trade or business.	May be deducted, amortized, or capitalized. See <i>Start-Up Costs and Organizational Costs</i> , page 20-6.
Tax-exempt interest	Federally tax-exempt interest income, including any exempt-interest dividends from a mutual fund.	Line 18a, Schedule K, and box 18, Schedule K-1, Code A.

Penalties

Late filing. The penalty for failing to file a partnership return by the due date, including extensions, or filing a return that fails to show all the information required, is \$195 for each month or part of a month the failure continues times the number of partners, up to 12 months.

Schedule K-1. A \$250 penalty applies for each failure to timely issue Schedule K-1 to a partner or failure to provide required information. The penalty may be increased if the failure to provide the schedule is intentional.

Reasonable cause. The penalties listed above may be waived for reasonable cause. Domestic partnerships with 10 or fewer partners will meet the reasonable cause test if:

- All partners are individuals (other than nonresident aliens), estates, or C corporations,
- All partners have timely filed income tax returns, fully reporting their shares of the partnership's income, deductions, and credits,
- The partnership has not elected to be subject to the rules for consolidated audit proceedings, and
- Each partner's share of each partnership item is the same as the partner's share of every other item. (Rev. Proc. 84-35)

Amended Partnership Return

The procedures for filing an amended partnership return depend on whether the amended return is filed electronically or on paper. The rules for determining when a return must be filed electronically also apply to amended returns. See *Electronic Filing*, page 20-1.

Electronic. Complete Form 1065 and check box G(5) to indicate an amended return. Attach a statement that identifies the line number of each amended item, the corrected amount or treatment of the item, and an explanation of the reason(s) for each change. If the information provided to any partner of Schedule K-1 is incorrect, file an amended Schedule K-1 for that partner with the amended Form 1065 and give a copy of the amended Schedule K-1 to the partner. Check the "Amended K-1" box at the top of the schedule.

Exception: If the partnership filing an amended return is subject to the consolidated audit proceedings of IRC sections 6221 through 6234, commonly called TEFRA proceedings, the tax matters partner must file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*.

Paper. If the amended return will not be filed electronically, complete Form 1065X, *Amended Return or Administrative Adjustment Request (AAR)*. If the corrected amount involves an item of income, deduction, or credit that must be supported with a schedule, statement, or form, attach the supporting document to Form 1065X.

Partnership Advantages/Disadvantages

Advantages	Disadvantages
<p>Flexibility. A partnership can make special allocations or distributions among partners for non-pro-rata shares of income and deductions.</p> <p>Simplicity. For tax purposes, a formal partnership agreement is not required (a written partnership agreement is recommended. See <i>Business Agreements</i>, page 24-1 for information about written partnership agreements). A verbal agreement is generally all that is required to form a partnership.</p> <p>Flow-through income. Income and deductions from a partnership flow through to the partners.</p>	<p>Liability. A general partner is liable for debts of the partnership, including debts that have been incurred by another person. An LLC formed under state law can shield partners from liability.</p> <p>Self-employment tax. The distributive share of income from a partnership is subject to SE tax for general partners.</p> <p>Commitment. It is often said that a partnership is easier to get into than to get out of. Written partnership agreements should contain an escape clause.</p>

See *Business Entity Comparison Chart*, page 31-2, *Small Business Edition*, for more information about advantages and disadvantages of different business entities.

Cross References

- Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*
- Form 1065, *U.S. Return of Partnership Income*
- IRS Pub. 541, *Partnerships*
- IRC Subchapter K, IRC §701 through IRC §777



Related Topics

- Business Entity Comparison Chart, page 31-2, *Small Business Edition*
- Partnership K-1 Codes, page 7-2, *1040 Edition/Deluxe Edition*
- Part II—Partnerships and S corporations, page 7-4, *1040 Edition/Deluxe Edition*.
- Business Agreements, page 24-1
- Partner's Adjusted Basis Worksheet, page 24-6
- Partnership Distributions—Disguised Sales, page 32-7, *Small Business Edition*

Partnership Defined

An unincorporated organization with two or more members is a partnership by default for federal tax purposes if its members carry on a trade, business, or financial operation and divide profits.

Co-ownership. Co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

Sharing expenses. A joint undertaking merely to share expenses is not a partnership.

Electing large partnership. A regular partnership is required to separately report certain items that may be treated differently depending on the partner's individual return. An "electing large partnership" combines most items at the partnership level and passes through net amounts to partners.

A partnership chooses electing large partnership status by filing Form 1065-B, *U.S. Return of Income for Electing Large Partnerships*. To make the election, the partnership must have had 100 or more partners during the preceding year. Therefore, a partnership cannot make the election for its first tax year.

General partnership. A general partnership is composed of only general partners. A general partner is a partner who is personally liable for partnership debts.

Limited partnership. A limited partnership is formed under a state limited partnership law and composed of at least one general partner and one or more limited partners.

Limited liability partnership (LLP). An LLP is formed under state law. Generally, a partner in an LLP is not personally liable for the acts or omissions of any other partner, solely by reason of being a partner. See *Limited Liability Partnerships (LLPs)*, page 20-17.

Limited liability companies (LLCs). An LLC is an entity formed under state law. An LLC with at least two members is classified as a partnership for federal tax purposes unless the entity files Form 8832, *Entity Classification Election*, to elect to be taxed as a corporation. See *Limited Liability Companies (LLCs)*, page 20-14.

Anti-abuse rule. If, based on all of the facts and circumstances, a partnership appears to be formed for the principal purpose of substantially reducing the partners' federal tax liability with no bona fide business purpose, the partnership may be disregarded and the claimed tax benefits disallowed. (Reg. §1.701-2)

Entity classification election. For information on entity classification elections, see *Entity Classification Election*, page 18-14.

Spousal Partnerships

Generally, if spouses jointly own and operate an unincorporated business and share the profits and losses, they are partners in a partnership and must file Form 1065.

Qualified joint venture. If spouses materially participate as the only members of a jointly owned and operated business, and they file a joint return for the tax year, they can elect to be treated as a qualified joint venture instead of a partnership. A qualified joint venture is one where:

- The only members of the joint venture are spouses,
- Both spouses materially participate in the trade or business,
- The business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or LLC, and
- Both spouses elect to have the provision apply.

To make the election, divide all items of income, gain, loss, deduction, and credit between spouses in accordance with their respective interests in the venture. Each spouse must file a separate Schedule C or F. Each spouse must also file a separate Schedule SE to pay self-employment tax. Once made, the election cannot be revoked without IRS consent.

Family Partnerships

Family members can be partners. However, certain provisions apply to make sure that family partnerships are not used for abusive income-shifting purposes.



A family member will be recognized as a partner only if one of the following requirements is met.

- If capital is a material income-producing factor (such as for inventory), the family member must have acquired the capital interest in a bona fide transaction (which can include a gift or purchase from another family member). The family member must also own and control the partnership interest.
- If capital is not a material income-producing factor (a service business, for example), the partners joined together in good faith to conduct a business. The partners must have agreed that contributions of each entitle the partners to a share in the profits, and some capital or service has been provided by each partner.

➔ **Planning Tip:** With the above restrictions in place for family partnerships, the strategy to shift income may be more desirable if younger children are simply paid a fair wage for their services. Children under 18 are not subject to payroll taxes, provided all partners are parents. Creating a partnership interest for a child by gifting may be more appropriate for working-age children who wish to enter the business and increase their involvement and control over time. See *Family Businesses—Employing Family Members*, page 5-19, 1040 Edition/Deluxe Edition.

Exclusion From Partnership Treatment

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes. All the partners must agree to make the choice, and the partners must be able to compute their own taxable income without computing the partnership's income.

The partners are not exempt from the rule that limits a partner's distributive share of partnership loss to the adjusted basis of the partner's interest in the partnership. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year.

Investing partnerships. A partnership that engages in the joint purchase and sale of investment property may elect out of partnership treatment. To be eligible:

- The partnership may not engage in the active conduct of trade or business.
- The partners must own the property as co-owners.

- The partners must reserve the right to dispose of their shares of the property.

Operating agreement groups. A partnership that engages in the joint production, extraction, or use of property may elect out of partnership treatment. To be eligible:

- The partners must own the property as co-owners.
- The partners must reserve the right to separately dispose of their shares of any property produced or extracted.
- The partners must not jointly sell services or property produced or extracted.

Making the election out of partnership treatment. An eligible organization that wishes to be completely excluded from partnership treatment must make the election no later than the time for filing, including extensions, for the partnership return for the first tax year for which the exclusion is desired. [Reg. §1.761-2(b)]

To make the election, file a blank Form 1065 with a statement attached containing:

- Names, addresses, and TINs of all the members of the organization.
- A statement that the organization qualifies under Regulation section 1.761-2(a)(2) [investing partnership] or section 1.761-2(a)(3) [operating agreement].
- A statement that all the members of the organization elect that it be excluded from all of Subchapter K.
- A statement indicating where a copy of the agreement under which the organization operates is available.



Did You Know? Even with a valid exclusion from partnership treatment in place, a business can be treated as a partnership under certain sections of the tax code. For example, in *Cokes, 91 T.C. No. 222*, the court found that even though an operating agreement group had a valid election out of partnership treatment, income to a recipient was subject to SE tax on distributive share of partnership income. From the court case: "The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of Subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed."

Partial election out of partnership treatment. A partnership may be allowed to elect out of certain provisions of partnership rules by filing a request with the IRS. [Reg. §1.761-2(c)]

General and Limited Partners

General partner. A general partner is a partner who is personally liable for partnership debts. A general partner is subject to SE tax on guaranteed payments and on the distributive share of partnership income.

Limited partner. A limited partner is liable only for the amount of money or other property that the partner contributed, or is required to contribute, to the partnership. A limited partner is subject to SE tax on guaranteed payments but is not subject to SE tax on the distributive share of income.

LLC members. An LLC with more than one owner is treated as a partnership by default, unless the LLC elects to be taxed as a corporation. Members of an LLC are subject to SE tax on guaranteed payments, but confusion exists as to whether and when LLC members are subject to SE tax on the distributive share of income. See *Limited partners vs. LLC members*, page 20-14, and *Self-Employment Tax*, page 5-23, 1040 Edition/Deluxe Edition, for more information about the questions surrounding SE tax for LLC members.

Tax Matters Partner. The Tax Matters Partner (TMP) is the person who has primary responsibility for communicating with the IRS regarding the partnership's tax return. The TMP must be a general partner or, in the case of an LLC, a member-manager. The

TMP is designated and provides contact information on page 3, Form 1065.

Fundamentals of Partnership Taxation

Flow-through income and deductions. A partnership does not pay income tax at the entity level. Income, losses, deductions, and credits from a partnership flow through and are reported on the partners' tax returns. Where individuals are partners, partnership rules are designed to make sure items are treated the same on the individual return as they would be if reported directly by the individual. For example, if two individuals operate a trade or business as a partnership, net profit has the same effect on their returns as if the income were reported on the individual's Schedules C and SE.

Example: George operates a business as a sole proprietorship. His net profit from self-employment in 2014 was \$35,000, which he reported as ordinary income on Schedule C and also on Schedule SE. Joy also owns a sole proprietorship. Her profit from self-employment in 2014 was \$65,000, which she reported as ordinary income on Schedule C and also on Schedule SE.

On January 1, 2015, George and Joy decided to go into business together and form a partnership. Both will be general partners. Based on the amount invested by each, and in keeping with their partnership agreement, George's distributive share of income is 35%, and Joy's is 65%. For 2015, assume the same amount of net profit as in 2014. The partnership's net profit for 2015 is \$100,000 (\$35,000 + \$65,000).

Partnership profit for 2015	\$100,000
Passed through to George at 35% distributive share	\$ 35,000
Passed through to Joy at 65% distributive share	\$ 65,000

George and Joy each report their distributive share of partnership profit as ordinary income on their Forms 1040, and the amounts are subject to SE tax. This results in the same gross income and amount subject to SE tax as each had in 2014.

Reporting pass-through income. Income and deductions from a partnership flow through to partners on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* See *Schedules K and K-1 (Form 1065)*, page 20-21.

The following fundamentals apply with respect to a partner reporting partnership income.

- Income or loss from the partnership is reported on the partner's tax return whether or not the amounts have been distributed.
- Distributions from a partnership are generally not taxable to the partner up to the partner's adjusted basis in the partnership interest.
- Distributive share of income from a partnership increases the partner's basis in the partnership interest.
- Distributive share of losses from a partnership decreases the partner's basis in the partnership.

See *Partner's Basis In the Partnership (Outside Basis)*, page 20-9, and *Partnership Distributions*, page 20-11.



Example: Gordie is a partner in Deerwalk Partnership. His basis in the partnership at the end of 2013 was \$800. For 2014, Schedule K-1 reported Gordie's share of partnership income as \$1,200. Gordie received no distributions from the partnership in 2014. He reported the \$1,200 as taxable income in 2014 even though he received no distributions.

On January 6, 2015, Gordie took a distribution of \$1,800 cash from the partnership. His distributive share of income from the partnership for 2015 was \$150. The distribution of \$1,800 cash is not taxable to Gordie.

Basis in partnership interest, 12/31/13	\$ 800
Distributive share of income (taxable), 2014	\$1,200
Adjusted basis, 12/31/14	\$2,000
Cash distribution (not taxable), 2015	(1,800)
Distributive share of income, 2015	150
Adjusted basis, 12/31/15	\$ 350

Reporting partner's share of income or loss. Income or loss from a partnership's trade or business activities are netted as "Ordinary business income (loss)" on line 22, Form 1065. The partner's share of ordinary income or loss flows through to the partner's individual return based on the partner's distributive share. If there is no special allocation contained within the partnership agreement, the partner's distributive share equals the partner's percentage of ownership interest in the partnership. See *Distributive Share*, page 20-6.

Individual partners generally report income or loss from trade or business activities on Part II, page 2, Schedule E (Form 1040). Losses are subject to at-risk rules and passive loss limitations. For information about at-risk rules, see *At-Risk Rules*, page 7-14, *1040 Edition/Deluxe Edition*. For information about passive loss limitations, see *Passive Activity Losses*, page 7-9, *1040 Edition/Deluxe Edition*. Amounts subject to self-employment (SE) tax are also reported on Schedule SE (Form 1040). For information about SE tax, see *Self-Employment Tax*, page 5-23, *1040 Edition/Deluxe Edition*.

A general partner's distributive share of business income is subject to SE tax if the partner is an individual. A limited partner's distributive share of business income is not subject to SE tax. Guaranteed payments are subject to SE tax for both general and limited partners. See *Guaranteed Payments*, page 20-6.

Partnership Agreement

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the agreement. The agreement or modifications can be oral or written.

Partners can modify the agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extension of time. If the agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement. For more information, see *Business Agreements*, page 24-1.

Partnership Tax Year

A partnership must generally conform its tax year to its partners' tax years. Therefore, a calendar year is required for a partnership that has individuals as partners. See *Accounting Periods*, page 8-23, *1040 Edition/Deluxe Edition*, for information about possible tax years other than a calendar year.

Partnership Income and Expenses

Cross References

- Form 1065, *U.S. Return of Partnership Income*
- IRS Pub. 535, *Business Expenses*
- IRS Pub. 541, *Partnerships*
- IRC §702, *Income and credits of partner*



Related Topics

- Self-employed health insurance deduction, page 5-9, *1040 Edition/Deluxe Edition*
- Rental, Passive, and At-Risk, Tab 7, *1040 Edition/Deluxe Edition*
- Business Deductions, Tab 8, *1040 Edition/Deluxe Edition*
- Business Agreements, page 24-1

Trade or Business Income (Loss)

Income and deductions from partnership trade or business activities are reported on page 1, Form 1065. Net ordinary income or loss is reported on line 22, Form 1065. Ordinary income or loss is passed through to the partners according to the partners' distributive share of income.

Did You Know? The not-for-profit activity limitation of IRC section 183 applies to partnerships (Rev. Rul. 77-320). See *Hobby Loss Rules*, page 5-19, 1040 Edition/Deluxe Edition.

Start-Up Costs and Organizational Costs

Up to \$5,000 of start-up costs and \$5,000 organizational costs may be deducted in the year the partnership begins business. The deduction is phased out dollar-for-dollar when start-up costs (or organizational costs) exceed \$50,000. Remaining costs must be amortized over a 180-month period. In lieu of the deduction, taxpayers may elect to capitalize and amortize all costs. See *Organizational Costs and Start-Up Costs: Statement of Election to Amortize*, page 24-10.

Start-up costs. Start-up costs are amounts paid or incurred for creating or investigating the creation or purchase of an active trade or business. The costs are incurred before the active trade or business begins.

Organizational costs. The costs to organize a partnership are the direct costs of creating the partnership. A cost must meet the following tests.

- It is for the creation of the partnership and not for starting or operating the partnership trade or business.
- It is chargeable to a capital account.
- It could be amortized over the life of the partnership if the partnership had a fixed life.
- It is incurred by the due date of the partnership return (excluding extensions) for the first tax year in which the partnership is in business. **Exception:** See *Cash method partnership*, below.
- It is for a type of item normally expected to benefit the partnership throughout its entire life.

Qualifying Costs	Nonqualifying Costs
<ul style="list-style-type: none"> • Legal fees incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement. • Accounting fees incident to the organization of the partnership. • Filing fees. 	<ul style="list-style-type: none"> • Acquiring assets for the partnership or transferring assets to the partnership. • Admitting or removing partners, other than at the time the partnership is first organized. • Making a contract concerning the operation of the partnership business including a contract between a partner and the partnership. • Syndication fees for issuing and marketing interests in the partnership.

Cash method partnership. A partnership using the cash method of accounting can deduct an organizational cost only if it has been paid by the end of the tax year. Any cost the partnership could have deducted in an earlier tax year, if it had been paid that year, can be deducted in the year of payment.

Liquidation of partnership. If a partnership is liquidated before the end of the amortization period, the unamortized amount can be deducted in the partnership's final tax year to the extent the costs qualify as a loss from a business.

For more information, see *Start-Up/Organization Costs*, page 8-18, 1040 Edition/Deluxe Edition.



Distributive Share

The partnership agreement generally determines a partner's distributive share of any item of income, gain, loss, deduction, or credit. If the partnership agreement does not provide for an allocation, the distributive share is equal to the partner's percentage of ownership interest in the partnership.

Special allocations. A partnership agreement can allocate partnership items in percentages other than according to the partners' ownership interests. However, an allocation will be disregarded if it does not have "substantial economic effect." An allocation has substantial economic effect if both the following tests are met.

- There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners' shares of partnership income or loss, independent of tax consequences.
- The partner to whom the allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

Allocation attributable to a nonrecourse liability. An allocation of a loss, deduction, or expense attributable to a partnership nonrecourse liability does not have any economic effect because the partner does not bear the economic burden corresponding to that allocation. Therefore, the partner's distributive share of the item must be determined by his or her interest in the partnership. See *Effect of Partnership Liabilities*, page 20-9. (Reg. §1.704-2)

Guaranteed Payments

Guaranteed payments are payments made to partners without regard for the profit or loss from partnership activities. Guaranteed payments are deducted from partnership income in determining the distributive share of income or loss passing through to partners.

Guaranteed payments are the equivalent of wages for a shareholder-employee of a corporation. Guaranteed payments are generally based on services rendered, rather than a percentage of partnership income. The flexibility in providing guaranteed payments allows a partnership to compensate partners for different levels of service without requiring special allocations.

Example: Rachel and Kendall each contribute \$30,000 to a partnership and each becomes a 50% owner. During the year, Rachel works 1,000 hours on partnership business, and Kendall works 400 hours on partnership business. Guaranteed payments will equal \$15 per hour for each partner. For the year, the partnership earns \$40,000 in net profits before deducting guaranteed payments.

Rachel's guaranteed payment for the year is \$15,000, and Kendall's is \$6,000. Of the remaining \$19,000 (\$40,000 profit – \$15,000 – \$6,000), each partner receives \$9,500 as a distributive share (\$19,000 × 50%).

The guaranteed payments allow the partnership to compensate Rachel for a greater amount of work without any special allocations of partnership net income.

Author's Comment: It is not uncommon to see partnerships pay partners as employees, withhold taxes, and issue W-2 forms at the end of the year. However, according to Revenue Ruling 69-184, a partner should not be treated as an employee of a partnership and is not subject to employee withholding for FICA, FUTA, or federal income tax. Partners should be compensated with guaranteed payments and should not be treated as employees by a partnership.

Minimum payment. If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

Example: Under a partnership agreement, John is to receive 30% of the partnership income, but not less than \$8,000. The partnership has a net income of \$20,000. John's share, without taking the guaranteed payment into account, is \$6,000 (\$20,000 × 30%). John's guaranteed payment is \$2,000 (\$8,000 minimum payment minus \$6,000 distributive share). If the partnership's income was \$30,000, there would have been no guaranteed payment because John's distributive share would have been \$9,000 (\$30,000 × 30%).

Separately Stated Items

Certain items may be treated differently among partners depending on their individual tax situations. Items such as capital gains or losses, charitable contributions, and Section 179 expense

deductions are stated separately on the partner's Schedule K-1 to ensure proper computation on the individual return.

Capital gains or losses. Partnerships use Form 8949, *Sales and Other Dispositions of Capital Assets*, to report the sale or exchange of assets held for investment. Totals from Form 8949 are carried to Schedule D, Form 1065. Gains or losses flow through to partners on Schedules K and K-1, line 8 (short term) or Schedules K and K-1, line 9a (long term).

Special disclosure for certain disposals of business property. Special rules apply if any property is disposed by an S corporation or partnership for which Section 179 was ever taken. Instead of the partnership or S corporation reporting on Form 4797, 6252, 4684, or 8824, each partner or shareholder will report on such forms using information flowing through on Schedule K-1. The following information should be reported by the partnership or S corporation for each sale.

- Description of property.
- Date the property was acquired and placed in service.
- Date of the sale or other disposition of the property.
- Partner's or shareholder's share of gross proceeds or amount realized.
- Partner's or shareholder's share of the cost or other basis, plus selling expenses.
- Partner's or shareholder's share of allowed or allowable depreciation exclusive of Section 179 deduction.
- Partner's share of any Section 179 expense deduction and years to which the amounts were passed through.
- If the disposition is due to casualty or theft, a statement indicating so and any additional information required by the partner-shareholder to complete Form 4684, *Casualties and Thefts*.
- If the disposition was an installment sale, any information required by the partner-shareholder to complete Form 6252, *Installment Sale Income*.
- If the disposition was property given up in a like-kind exchange, any information required by the partner-shareholder to complete Form 8824, *Like-Kind Exchanges*.



Disposition of property may result in a reduction of unused Section 179 deduction carried over by the partners or shareholders. See the instructions for Form 4797, *Sales of Business Property*, for a worksheet that computes gain or loss on dispositions described above.

Character of pass-through items. Income or losses passing through from a partnership retain their character. The partner is required to treat items passing through from a partnership in the same manner as the item was treated by the partnership. For example, rental income earned by the partnership is passed through and reported as rental income by the partner.

Charitable contributions. All partnerships generally must file Form 8283, *Noncash Charitable Contributions*, if noncash contributions exceed \$500. The partnership must attach a copy of its Form 8283 to the Schedule K-1 of each partner if the deduction for any item or group of similar items of contributed property exceeds \$5,000, even if the amount allocated to any partner is \$5,000 or less.

Self-employed health insurance premiums. Premiums for health insurance paid by a partnership on behalf of a partner for services rendered are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include the payments in gross income. See *Self-employed health insurance deduction*, page 5-9, 1040 Edition/Deluxe Edition.

Limit on Losses

A partner's distributive share of partnership loss may be limited by one of the following:

- Hobby Loss Rules, page 5-19, 1040 Edition/Deluxe Edition.
- Passive Activity Losses, page 7-9, 1040 Edition/Deluxe Edition.
- At-Risk Rules, page 7-14, 1040 Edition/Deluxe Edition.

- Partner's adjusted basis, see *Partner's Basis In the Partnership (Outside Basis)*, page 20-9.

Related party loss limitations. No deduction is allowed for losses from sales or exchanges of property (other than an interest in a partnership), directly or indirectly between:

- A partnership and a person owning, directly or indirectly, more than 50% of the capital interests or profits interest of the partnership, or
- Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

If the purchaser sells the property at a later date, gain is recognized to the extent that gain exceeds the previously disallowed loss.



Timing of Income

For information on partnership fiscal year limitations, see *Required Tax Year for Partnerships*, page 8-24, 1040 Edition/Deluxe Edition.

Accrual-basis payment to cash-basis partner. An accrual-basis taxpayer may not deduct an expense accrued to a cash-basis related party until the amount has been included in the income of the recipient. [IRC §267(a)(2)]

Change in Partnership Interest

The ownership percentage of partners can fluctuate during the year because of additional capital contributions, liquidation of a partner's interest, entry of a new partner, etc. Partnership items passing through to partners must reflect any changes in ownership interests that occurred during the year. If there is not a special allocation spelled out on the partnership agreement, the shares of partnership items are based on the percentage of ownership of each partner and the time held during the year. The computation is similar to the per-share-per-day method of allocating S corporation income to shareholders. See *Pro-Rata Allocation/Per-Share/Per-Day*, page 19-6.

Example: On January 1, 2015, Randy and Julie were equal partners in RJ Partnership. On April 1, 2015, Eric joined the partnership as 20% owner. The partnership agreement allocates partnership items to be distributed to partners based on their ownership interests. During 2015, RJ Partnership had \$96,000 of ordinary income, which was earned evenly throughout the year. The partners' distributive shares of income are computed as follows.



	Ownership Interest	Percentage of Year Held	Partnership Income	Partner's Distributive Share
Randy	50%	× 25%	× \$96,000	\$12,000
	40%	× 75%	× \$96,000	\$28,800
Julie	50%	× 25%	× \$96,000	\$12,000
	40%	× 75%	× \$96,000	\$28,800
Eric.....	20%	× 75%	× \$96,000	\$14,400
Total				\$96,000

Closing the books. Under the general rule, for purposes of determining distributive share upon sale, exchange, or liquidation of a partner's entire interest in a partnership, the partnership's tax year shall close with respect to the departing partner. This leaves the partner with a distributive share of items attributable only to the time the partner owned the partnership interest.

Note: A partnership taxable year with respect to a partner who dies shall not close prior to the end of the partnership year.

In order to avoid an interim closing of the books, the departing partner's distributive share of items may be estimated by taking the partner's pro rata part of what would have been included in taxable income had the partner remained until the end of the tax year. Any reasonable method may be used to determine the pro rata portion. This method of determining distributive share requires the agreement of all the partners. [Reg. §1.706-1(c)(2)]

Unreimbursed Partnership Expenses

Under the general rule, a partner is not allowed to deduct partnership expenses on his or her individual tax return. However, an exception applies when there is a provision in the partnership agreement requiring the partner to pay the expenses, or if payment of the expenses is a routine partnership practice tantamount to an agreement. See *Partnership Agreement*, page 20-5.

Allowable expenses are deducted on Part II, Schedule E (Form 1040). Report allowable unreimbursed partnership expenses as a separate item from partnership income on line 28, Schedule E. Enter "UPE" as the name of the line item, then list the amount on (h) of line 28. The expense will be deducted from partnership income and will also reduce net income subject to self-employment tax.

See the illustration of Schedule E of the *Partnership Example*, page 20-26, for an example of how to report unreimbursed partnership expenses.

Business use of the home. Partners report expenses for business use of the home as unreimbursed partnership expenses on line 28, Schedule E, Form 1040. Do not use Form 8829, *Expenses for Business Use of the Home*, for a partner's expenses. Instead use the worksheet in IRS Pub. 587, *Business Use of Your Home*. See *Business Use of Home*, page 5-12, 1040 Edition/Deluxe Edition.

Author's Comment: Include the requirement that the partners pay specific expenses in the written partnership agreement to help ensure deductibility in case of a challenge by the IRS. Also include wording that the partnership will not reimburse partners for the expenses.

Court Case: An individual partner claimed unreimbursed partnership expenses of \$33,415 against partnership income of \$49,537. The Tax Court did not allow the expenses, stating that the partner was not required by the partnership agreement to make such payments, and there was no proof that there was a level of routine partnership practice to do so. Although the partner claimed that under a verbal agreement reimbursement for the expenses would not be made by the partnership, the court disregarded the testimony as "self-serving, unverified, and undocumented." The Tax Court not only disallowed the deduction, but also imposed an accuracy-related penalty. (*Hines*, T.C. Summary 2004-55)

Note: A shareholder of an S corporation does not have a similar provision for deducting unreimbursed corporate expenses on Schedule E. If the shareholder pays an expense on behalf of the corporation without reimbursement, the expense may be non-deductible. See *Paying Expenses of an Employer*, page 8-13, 1040 Edition/Deluxe Edition.

Basis

Cross References

- IRS Pub. 541, *Partnerships*
- IRC §83, IRC §722, IRC §723, IRC §754

Related Topics

- At-Risk Rules, page 7-14, 1040 Edition/Deluxe Edition
- Partner's Adjusted Basis Worksheet, page 24-6



Partnership (Inside) Basis

The partnership's basis in its assets is known as "inside basis." In addition to contributions of property, the partnership may acquire property by means of purchase.

Generally, the partnership's basis in contributed property is the same as the adjusted basis of the property in the hands of the contributing partner at the time of the contribution. Similarly, the partnership has a holding period in the property which dates back to the contributor's acquisition of the property. The partnership

depreciates the contributed property as if the partner still held the property.

Example: O'Houlihan was a restaurant owner who operated as a sole proprietor. On June 1, 2013, O'Houlihan purchased a computer for use in his business at a cost of \$900. The computer has a MACRS recovery period of five years.

On January 1, 2015, O'Houlihan formed a partnership with MacScottigan. O'Houlihan contributed his computer in exchange for his partnership interest. The depreciation on the computer is deducted as follows:

Year	Basis	MACRS Percentage	Deducted on O'Houlihan's Form 1040	Deducted on the partnership's Form 1065
2013	\$900	20.00%	\$180	
2014	\$900	32.00%	\$288	
2015	\$900	19.20%		\$173
2016	\$900	11.52%		\$104
2017	\$900	11.52%		\$104
2018	\$900	5.76%		\$51

O'Houlihan and MacScottigan Partnership's holding period for the computer began on June 1, 2013.



Partner's Outside Basis Compared to Partner's Capital Account

	Outside Basis	Capital Account
Description	Adjusted basis of the partner's partnership interest.	Partner's equity investment in the partnership.
Additional contributions	Increase.	Increase.
Distributions	Decrease. ¹	Decrease.
Distributive share of income	Increase.	Increase.
Distributive share of losses	Decrease. ¹	Decrease.
Book value adjustments to partnership property	No effect. ²	Can be increased or decreased by adjustments to book value of partnership property. ^{3,4}
Partnership liabilities	Any increase or decrease in a partner's allocable share of partnership liabilities will increase or decrease the partner's outside basis. ¹ [IRC §752]	A partner's capital account is neither increased nor decreased by partnership liabilities.
Negative basis	A partner's outside basis may never go below zero. <ul style="list-style-type: none"> • Deductions in excess of outside basis are not permitted. [IRC §704(d)] • A partner must recognize gain to the extent that distributions of money reduce his or her outside basis below zero. [IRC §731(a)(1)] 	A partner is permitted to have a negative capital account as a result of his or her distributive share of losses or by distributions. This negative amount typically represents the amount of cash the partner would owe the partnership upon liquidation.

¹ A partner's outside basis may never be decreased below zero.

² The outside basis of a partner contributing property to a partnership is increased by his or her basis in the contributed property regardless of its FMV.

³ The capital account of a partner contributing property to a partnership is increased by the property's FMV at the time of the contribution, regardless of the partner's basis in the property.

⁴ Although certain adjustments are allowed by regulations, the method of adjusting the capital account must have substantial economic effect. [Reg. §1.704-1(b)(2)(iv)(d)]

Partner's Basis in the Partnership (Outside Basis)

A partnership interest is an item of property. Like any other item of property, it has a basis for tax purposes. A partner's basis in his or her partnership interest is referred to as "outside basis." Upon formation of the partnership, a partner's initial outside basis will generally equal the amount of money and the adjusted basis of property contributed. If the partner purchases his or her partnership interest, the outside basis will equal the purchase price.

Contribution of property. No gain or loss is recognized to a partnership, or to any of its partners, when property is contributed to the partnership in exchange for a partnership interest. (IRC §721)

Basis Increases	Basis Decreases
<p><i>A partner's basis is increased by the following:</i></p> <ul style="list-style-type: none"> • The partner's additional contributions to the partnership, including an increased share of or assumption of partnership liabilities. • The partner's distributive share of taxable and nontaxable partnership income. • The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners. 	<p><i>A partner's basis is decreased (but never below zero) by the following:</i></p> <ul style="list-style-type: none"> • The money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership. • The partner's distributive share of the partnership losses (including capital losses). • The partner's distributive share of nondeductible partnership expenses that are not capital expenditures. This includes the partner's share of any Section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return. See <i>Section 179 Expense</i>, page 9-6, 1040 Edition/Deluxe Edition. • The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.

Effect of Partnership Liabilities

A partner's basis in a partnership interest includes the partner's share of partnership liabilities if the liability:

- Creates or increases the partnership's basis in any of its assets,
- Gives rise to a current deduction to the partnership, or
- Is a nondeductible, noncapital expense of the partnership.

Increases. If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, the increase is treated as a contribution of money by the partner to the partnership.

Decreases. If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, the decrease is treated as a distribution of money to the partner by the partnership.

Assumption of liability. A partner or related person is considered to assume a partnership liability only to the extent that:

- The partner is personally liable for the debt,
- The creditor knows that the liability was assumed by the partner or related person,
- The creditor can demand payment from the partner or related person, and
- No other partner or person related to another partner will bear the economic risk of loss on that liability immediately after the assumption.

Related person. Related persons for these rules include, but are not limited to, the following.

- An individual and his or her spouse, ancestors, and lineal descendants.



- An individual and a corporation if the individual directly or indirectly owns 80% or more in value of the outstanding stock of the corporation.
- Two corporations that are members of the same controlled group.
- A grantor and a fiduciary of any trust.
- A partnership and a person owning, directly or indirectly, 80% or more of the capital or profits interests.

For a more detailed list, see IRS Pub. 541, *Partnerships*.

Partner's share of recourse liabilities. A partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss. A partner's share of a recourse liability equals his or her economic risk of loss for that liability. A partner has an economic risk of loss if that partner, or a related person, would be obligated to make a net payment to the creditor or a contribution to the partnership if the partnership were constructively liquidated.

Under general basis rules, both recourse and nonrecourse liabilities will increase a partner's basis in the partnership, but only recourse liabilities will increase a partner's at-risk basis. Since the at-risk rules limit deductible losses to the amount at risk in the activity, recourse liabilities are more relevant.

Contribution of Services

A partner can acquire an interest in partnership capital or profits as compensation for services performed.



Capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. The fair market value of services rendered in exchange for a capital interest in a partnership is taxable to the partner as a guaranteed payment and deductible by the partnership. The partner is then treated as contributing the guaranteed payment back to the partnership in exchange for a partnership interest. The partnership does not recognize gain or loss on the transfer.

Some service-like assets may be considered property. Courts have held that rights in certain assets, such as patents, goodwill, and technical knowledge, may qualify as property rather than services.

Profits interest. A profits interest is a partnership interest other than a capital interest. The receipt of a profits interest for providing services to a partnership in a partner capacity is not taxable to the partner or the partnership unless:

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets,
- The partner disposes of the profits interest within two years of receipt, or
- The profits interest is a limited partnership interest in a publicly traded partnership.

Alternative Rule for Computing Partner's Basis

In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated. This alternative rule can be used in either of the following situations.

- The circumstances are such that the partner cannot practically apply the general basis rules, or
- It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in figuring the basis of a partnership interest under the alternative rule. For example, adjustments would be required to include any significant discrepancies that

resulted from contributed property, transfers of partnership interest, or distributions of property to the partners. [Reg. §1.705-1(b)]

Example: Erica and Donna are 50/50 partners in the Flora Tax Office Partnership. They have been conducting business for years without maintaining capital accounts, basis calculations, or preparing balance sheets because income was always too low to require filling out Schedule L, Form 1065. Unfortunately, the tax office partnership profits dwindle, and eventually losses are reported. The partners need to reconstruct basis to determine treatment of losses on their individual returns. Assume the following partnership items:

Cash.....	\$ 1,000
Equipment (adjusted basis after depreciation).....	10,000
Liabilities.....	(3,000)
Total.....	\$ 8,000

Under the alternative rule for computing partners' basis, Erica and Donna each have a basis in their partnership interest of \$4,000.



Partner's Capital Account

Each partner's equity in the partnership is reflected in a capital account.

Generally, capital accounts reflect the FMV of assets at the time of contribution and distribution. The capital accounts show the partners' economic interest in the partnership.

Although certain adjustments are allowed by regulations, the method of adjusting the capital account must have substantial economic effect. [Reg. §1.704-1(b)(2)(iv)(d)]

The balance sheet reported on the partnership return reflects the total capital accounts of all partners. The recorded amount for each partner's capital account is generally in proportion to their respective interest in the partnership, but irregular distributions and special allocations of income may result in disproportionate capital balances. See *Special allocations*, page 20-6.

The capital account is not the same as basis. For example, when partners contribute noncash property, basis and capital will differ. Capital account balances and basis must be calculated independently. The capital account is calculated as follows:

- Initial FMV contribution,
- Plus additional capital contributions,
- Plus ratable allocations of income (including special allocations),
- Minus ratable distributions of capital,
- Minus ratable allocations of losses (including special allocations).



The partners' share of liabilities is not included in the capital account, although it does increase basis.

Schedule K-1. Item L of Schedule K-1 (Form 1065) shows an analysis of changes in the partner's capital account for the tax year.

Allocations to account for built-in gain or loss. When the fair market value of property at the time it is contributed to the partnership is different from the partner's adjusted basis, the partnership must allocate among the partners any income, deduction, gain, or loss on the property that will account for the difference.

Traditional method of allocation. Under the traditional method of allocation, if the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. [Reg. §1.704-3(b)]

Example: Jenny contributes \$50,000 in cash to Jenny Paul Partnership, and Paul contributes land with a FMV of \$50,000 and an adjusted basis of \$30,000 (built-in gain). The capital account is \$50,000 for each partner, and the partnership's adjusted basis in the land is \$30,000.

The partnership later sells the land for \$60,000. The \$30,000 gain on the land is allocated for tax purposes as follows:

Total gain.....	\$30,000
Built-in gain to Paul.....	\$20,000
Gain remaining.....	\$10,000
<i>50/50 split</i>	
Jenny.....	\$ 5,000
Paul.....	\$ 5,000
<i>Allocation of total gain</i>	
Jenny.....	\$ 5,000
Paul.....	\$25,000

The capital account is adjusted the same for Jenny and Paul. However, the allocation made under IRC section 704(c) shifts taxable income for the built-in gain on the property to Paul.

If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allocable to the partnership or the gain or loss realized by the partnership.

Example: Bruce and Tom form a 50/50 partnership. Bruce contributes \$10,000 in cash and Tom contributes depreciable property with a FMV of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Tom's hands, which is \$4,000.

In effect, Bruce purchased a one-half interest in the depreciable property with his contribution of \$10,000 to the partnership. For purposes of this illustration, assume a depreciation rate of 10% per year. Under regular depreciation principles, Bruce would have been entitled to depreciation of \$500 for the year ($\$10,000 \times 10\% = \$1,000 \times 50\% = \500). However, because the depreciable basis in the property is only \$4,000, no more than \$400 can be allocated between the partners.

The entire \$400 in depreciation is allocated to Bruce.



The partnership can use different allocation methods for different items of contributed property. However, a single reasonable method must be consistently applied to each item, and the overall combination of methods must be reasonable.

See Regulations section 1.704-3(c), *Traditional method with curative allocations* and section 1.704-3(d), *Remedial allocation method*, for examples of other methods accepted by the IRS for allocating built-in gain or loss for property contributed to a partnership.

Distribution of property to another partner within seven years. If a partner contributes property to a partnership, and the partnership distributes the property to another partner within seven years of the original contribution, the contributing partner must recognize gain or loss equal to the amount of built-in gain or loss at the time of contribution.


Distribution to contributing partner within seven years. If a partner contributes built-in gain property to a partnership, and within seven years that partner receives distributions from the partnership in excess of the partner's basis, the partner must recognize gain. The amount recognized is the lesser of the amount of built-in gain at the time of contribution, or the amount by which the distribution exceeded the partner's basis in the partnership. (IRC §737)

Installment sales and contributed contracts. Forward contracts, futures contracts, purchase options, and installment contracts contributed on or after November 24, 2003, are subject to built-in gains and seven-year distribution rules. (TD 9193)

IRC Section 754 Election to Adjust Basis of Partnership Property

An election is available that allows a partnership to adjust the basis of partnership property upon distribution of property (IRC §734) or when the transfer of a partnership interest occurs (IRC §743). The election can address inequities that occur when partnership interests are sold or transferred and the FMV of property is different from the adjusted basis.

Making the election. The IRC section 754 election is made by attaching a written statement to Form 1065 filed by the due date, including extensions. The statement must include the name and address of the partnership, be signed by one of the partners, and state that the partnership elects under IRC section 754 to apply IRC section 734(b) and IRC section 743(b). Once the election is made, it cannot be revoked without IRS consent. If the election cannot be made with the tax return, an extension of up to 12 months is available. See Treasury Regulation section 1.754-1(b) for more information about making an IRC section 754 election.

 **Author's Comment:** Since the election is irrevocable and all future transactions must follow the rules of IRC section 754, care should be taken when making the election as it may be advantageous for the current situation, but it may not be desirable for future transactions.

Mandatory basis adjustment. For partnership distributions after October 22, 2004, the basis adjustment rules of IRC section 734 and IRC section 743 are mandatory in the case of the transfer of a partnership interest where there is a substantial built-in loss or a partnership distribution where there is a substantial basis reduction.

- A substantial built-in loss exists with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in its property exceeds the FMV of the property by more than \$250,000.
- A substantial basis reduction exists if a downward basis adjustment of more than \$250,000 would be made to the basis of partnership assets if an optional basis adjustment election was in effect.

Example: IRC section 754 election in a distribution. Andrea, Bud, and Charles each have a 33% ownership in ABC Partnership. ABC Partnership distributes equipment with a FMV of \$28,000 to Andrea. Andrea's outside basis in ABC Partnership is \$25,000. The \$3,000 difference (gain to be recognized by Andrea) is allocated to Bud and Charles and any related depreciation deductions are specifically allocated to Bud and Charles. No entry is made to record the \$3,000 IRC section 754 asset on the books of the partnership, the \$3,000 is reflected in Bud and Charles's outside bases.

Note: In an IRC section 754 election the step-up or step-down of the remaining assets is allocated to Bud and Charles. This equalizes the partners by providing Bud and Charles with a tax asset equal to the asset that the Andrea received.

Example: IRC section 754 election in a transfer of an interest. Don and Emily are 50/50 owners of DE Partnership. Don's previously taxed capital in the partnership is \$25,000. Don sells his interest to Dave for \$40,000. The \$15,000 difference is allocated to Dave and any related depreciation/amortization deductions are specifically allocated to Dave. No entry is made to record the \$15,000 IRC section 754 asset on the books of the partnership, the \$15,000 is reflected in Dave's outside basis.

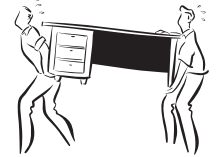
Note: When Dave acquired Don's interest in the partnership, the price was based on FMV. When assets in the partnership are greater in value than the outside basis, there is a distortion between Dave's outside basis and the proportionate value of the assets of the partnership. If an IRC section 754 election is made, the incoming partner receives a step-up or step-down for the difference between what is paid and the former partner's previously taxed capital. Any related depreciation/amortization deductions are specifically allocated to Dave.

Cross References

- IRS Pub. 541, *Partnerships*
- IRC §731 through IRC §737

Related Topics

- Capital Gains and Losses, page 6-7, 1040 Edition/Deluxe Edition
- Partner's Adjusted Basis Worksheet, page 24-6



Tax Effects of Distributions

A distribution to a partner will be either (1) a current distribution that does not completely retire the partner's interest in the partnership, or (2) a liquidating distribution that does retire the partner's interest in the partnership.

A partnership does not recognize gain on a distribution of money or property to a partner. [IRC §731(b)]

Current Distributions

A current distribution is any distribution that does not completely retire a partner's interest in the partnership.

A current distribution can either reduce the partner's capital account or can reduce the partner's ownership interest in the partnership.

Gain. Gain will not be recognized by a partner in a current distribution unless money is distributed. Gain is recognized only if the amount of money received exceeds the partner's adjusted basis in the partnership.

Example: Sylvester and Adrienne are partners in a partnership. Each partner receives a current distribution of \$5,000 in cash. Sylvester's adjusted basis in his partnership interest is \$6,000. Adrienne's adjusted basis in her partnership interest is \$3,000. The \$5,000 distribution to Sylvester is not taxable, but does reduce his basis to \$1,000 (\$6,000 minus \$5,000 distribution = \$1,000 adjusted basis).

Adrienne has a capital gain of \$2,000 (\$5,000 distribution against \$3,000 basis).



Loss. A loss will not be recognized by a partner on a current distribution.

Basis of property received in a current distribution. A partner's basis for property (other than money) received in a current distribution is the partnership's adjusted basis in the property. The property's basis is limited to the partner's adjusted basis in the partnership reduced by any money received in the same transaction. [IRC §732(a)]

Liquidating Distributions

A liquidating distribution retires a partner's interest in the partnership. A series of payments made as part of a liquidation plan are all treated as liquidating distributions.

Gain. A partner will recognize gain on a liquidating distribution to the extent that money distributed exceeds the partner's adjusted basis in his or her partnership interest.

Loss. A loss on a liquidating distribution can be recognized if cash, unrealized receivables, or inventory items are received by the partner. If any other property is distributed to the partner, the partner cannot recognize a loss.

The IRS challenged a noncash distribution to a partner in liquidation of his interest. The partnership purchased real estate shortly before the liquidation and distributed the property to the retiring partner. The partner claimed nonrecognition of gain since no cash was distributed. The IRS maintained the real estate served

no purpose other than to provide the partner with a noncash distribution and denied the partner nonrecognition of gain under IRC section 731. It was further discovered that this purchase was entirely orchestrated by the retiring partner himself, even to the extent of selecting the property. (Ltr. Rul. 200650014)

Liabilities

Assumption of liabilities by a partner is treated as payment of money to the partnership. Assumption of liabilities results in an increase in the partner's basis.

Conversely, a relief of liabilities is treated as money paid to the partner. The partner's basis is decreased by the amount of liabilities relieved.

Sale of Partnership Interest

The sale or exchange of a partner's interest in a partnership generally results in capital gain or loss. For exceptions, see *Payments for Unrealized Receivables and Inventory Items*, page 20-13.

Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any liabilities, that partner must include the liability relief as part of the amount realized.

Example: Fred became a partner in the Alphabet Partnership by contributing \$5,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of 2014 was \$20,000, which includes his \$15,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. In 2015, Fred sold his interest in the partnership for \$10,000 in cash.

Fred realizes \$25,000 from the sale (\$10,000 cash payment plus \$15,000 liability relief). Fred reports \$5,000 capital gain on his Form 1040 (\$25,000 realized less \$20,000 basis).



Disguised Sale Rules

A transfer of property (other than money or an obligation to contribute money) by the partner to the partnership, and a transfer of money or other consideration by the partnership to the partner, is treated as a sale by the partner to the partnership if both of the following are true. [Reg. §1.707-3(b)]

- The transfer of money or other consideration would not have been made but for the transfer of property, and
- In cases where the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

For purposes of disguised sale rules if, within a two-year period, a partner transfers property to a partnership, and the partnership transfers money or other consideration to the partner, the transfers are presumed to be a disguised sale unless the facts and circumstances clearly establish otherwise. [Reg. §1.707-3(c)]

Facts and circumstances. The presence of some or all of the following facts and circumstances may indicate that a disguised sale has taken place. [Reg. §1.707-3(b)(2)]

- The timing and amount of a subsequent transfer are determinable with reasonable certainty at the time of an earlier transfer,
- The transferor has a legally enforceable right to the subsequent transfer,
- The partner's right to receive the transfer of money or other consideration is secured in any manner, taking into account the period during which it is secured,
- Any person has made, or is legally obligated to make, contributions to the partnership in order to permit the partnership to make the transfer of money or other consideration,



- Any person has loaned, or has agreed to loan, the partnership the money or other consideration required to enable the partnership to make the transfer, taking into account whether any such lending obligation is subject to contingencies related to the results of partnership operations,
- The partnership has incurred, or is obligated to incur, debt to acquire the money or other consideration necessary to permit it to make the transfer, taking into account the likelihood that the partnership will be able to incur that debt,
- The partnership holds money or other liquid assets, beyond the reasonable needs of the business, that are expected to be available to make the transfer,
- Partnership distributions, allocations, or control of partnership operations is designed to effect an exchange of the burdens and benefits of ownership of property,
- The transfer of money or other consideration by the partnership to the partner is disproportionately large in relationship to the partner's general and continuing interest in partnership profits, and
- The partner has no obligation to return or repay the money or other consideration to the partnership, or has such an obligation, but it is likely to become due at such a distant point in the future that the present value of that obligation is small in relation to the amount of money or other consideration transferred by the partnership to the partner.



Form 8275. A partner must attach Form 8275, *Disclosure Statement*, to his or her return if the partner contributes property to a partnership and, within two years, the partnership transfers money or other consideration to the partner. A partnership must attach Form 8275 to its return if it distributes property to a partner, and, within two years, the partner transfers money or other consideration to the partnership.

Certain Distributions Treated as Sales or Exchanges

When a partnership distributes the following items, the distributions may be treated as a sale or exchange of property rather than a distribution.

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money.
- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables and/or substantially appreciated inventory items.
- Property distributed to satisfy guaranteed payments. Revenue ruling 2007-40 provides that a partnership must recognize gain or loss as if the property had been sold at FMV and may treat the amount as a guaranteed payment. See *Guaranteed Payments*, page 20-6.

Sale or exchange treatment does not apply to distributions of property to the partner who contributed the property to the partnership, or payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income.

Substantially appreciated inventory items. Inventory items are considered to have appreciated substantially in value if, at the time of the distribution, the total FMV is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

Payments for Unrealized Receivables and Inventory Items

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property. See *Liquidation at Partner's Retirement or Death*, next column.

Unrealized receivables. Unrealized receivables include any rights to payment not already included in income for the following items.

- Goods delivered, or to be delivered, to the extent the payment would be treated as received for property other than a capital asset.
- Services rendered or to be rendered.
- Unrealized receivables also include the amount of gain that would be treated as ordinary income such as section 1245 or section 1250 property.



Determining gain or loss. The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items is the amount that would have been allocated to the partner if the partnership had sold all its property for cash at FMV in a fully taxable transaction immediately prior to the partner's transfer of interest in the partnership.

Form 8308, Report of a Sale or Exchange of Certain Partnership Interests

Form 8308 is filed by a partnership to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items. Form 8308 is filed as an attachment to Form 1065 for the tax year of the partnership that includes the last day of the calendar year in which the exchange took place. The purpose of Form 8308 is to alert transferring partners that a portion of the gain from the exchange is treated as ordinary income.

Distribution of Inventory

If a partner receives a distribution of unrealized receivables or inventory, gain or loss on subsequent sale by the partner is ordinary gain or loss.

Exception: If the partner sells inventory items held for more than five years after the distribution, the type of gain or loss depends on how the items are being used on the date of sale. The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold. [Reg. §1.735-1(a)(2)]

Example: Sandra receives, through dissolution of her partnership, inventory that has a basis of \$19,000. Within five years, she sells the inventory for \$24,000. The \$5,000 gain is taxed as ordinary income. If Sandra had held the inventory for more than five years, her gain would have been capital gain, provided the inventory was a capital asset in her hands at the time of sale.

Liquidation at Partner's Retirement or Death

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments

include an assumption of the partner's share of partnership liabilities treated as a distribution of money.

For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

Liquidating payments. Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction for the partnership.

Unrealized receivables and goodwill.

Payments made for the retiring or deceased partner's share of the partnership's unrealized receivables or goodwill are not treated as made in exchange for partnership property if both of the following tests are met.

- Capital is not a material income-producing factor for the partnership. Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital (such as investments in inventory, plants, machinery, or equipment).
- The retiring or deceased partner was a general partner in the partnership.

However, this rule does not apply to payments for goodwill to the extent that the partnership agreement provides for a reasonable payment to a retiring partner for goodwill.

Gain or loss on distribution. Upon the receipt of the distribution, the retiring partner or successor in interest of a deceased partner will recognize gain only to the extent that any money distributed is more than the partner's adjusted basis in the partnership. The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received.

Other payments. Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in a partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are to be made. It applies to payments made for the partner's share of unrealized receivables and goodwill not treated as distributions.

- If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership.
- If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income. See *Guaranteed Payments*, page 20-6.
- These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.
- Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

Court Case: The taxpayer, a lawyer, claimed payments received from his firm after retirement were capital gain rather than ordinary income. The Tax Court held that the payments made in place of a retirement plan for the firm's partners were guaranteed payments reportable as ordinary income. The payments were related to years worked for the firm and not in any way related to the size of the partner's interest or the profits of the law firm. (*Wallis*, T.C. Memo. 2009-243)



Terminating a Partnership

Cross References

- IRS Pub. 541, *Partnerships*
- IRC §708, *Continuation of Partnership*

Related Topics

- *Accounting Periods*, page 8-23, 1040 Edition/Deluxe Edition
- *Short Tax Year Depreciation*, page 9-5, 1040 Edition/Deluxe Edition

A partnership terminates when one of the following events takes place.

- All the partnership operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership, or
- A technical termination occurs when at least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

Effect of termination by sale or exchange. If a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to have contributed all its assets and liabilities to a new partnership in exchange for an interest in the new partnership. Immediately thereafter, the terminated partnership is deemed to have distributed interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminating partnership. [Reg. §1.708-1(b)(4)]

When a partnership is terminated using the 50% rule, the new partnership retains the EIN of the terminated partnership. [Reg. §1.708-1(c)(2)]

Electing large partnership. Unlike other partnerships, an electing large partnership does not terminate on the sale or exchange of 50% or more of the partnership interests within a 12-month period. See *Electing large partnership*, page 20-3.

Date of termination. The partnership's tax year ends on the date of termination. For a partnership that terminated because operations are discontinued, the date of termination is the date the partnership completes the winding up of its affairs. For a partnership that terminates because of the 50% rule, the date of termination is the date of the sale or exchange of a partnership interest that, by itself or together with other sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both capital and profits.

Short year return. If a partnership terminates before the end of the tax year, Form 1065 must be filed for the short tax year. The return is due the 15th day of the fourth month following the date of termination. Also see *Accounting Periods*, page 8-23, 1040 Edition/Deluxe Edition, and *Short Tax Year Depreciation*, page 9-5, 1040 Edition/Deluxe Edition.

Limited Liability Companies (LLCs)

Cross References

- Form 8832, *Entity Classification Election*
- IRS Pub. 3402, *Taxation of Limited Liability Companies*

Related Topics

- Business Entity Comparison Chart, page 31-2, *Small Business Edition*
- C Corporations, Tab 18
- S Corporations, Tab 19



LLC Defined

An LLC is a business entity organized under state law. It combines the tax aspects of a partnership with the liability protection of a corporation. Each state has its own regulations for entities organized within its jurisdiction.

Ownership. Owners of an LLC are called members. Most states do not restrict ownership. Members may include individuals, corporations, other LLCs, and foreign entities. There is no maximum number of members. Most states also permit LLCs having only one owner, referred to as single-member LLCs.

Limited liability. Unlike general partners, who may be held personally liable for claims against the partnership, all of the members of an LLC have limited personal liability for its debts. This affects members' at-risk basis and basis for gain or loss. In contrast to a general partner, an LLC member's basis in partnership debt does not increase unless that member personally guarantees the debt.

Limited partners vs. LLC members. Clear guidance is lacking as to whether LLC members should be treated as general partners or limited partners. General partners are defined in regulations by virtue of their liability for partnership debts. By definition, LLC members are not liable for partnership debts. This creates confusion for issues such as self-employment tax on distributive share of income. See *General and Limited Partners*, page 20-4.

Court Case: Roughly 99% of the net business income of a limited liability partnership was derived from legal services rendered by the attorney/partners. The IRS determined that the attorney/partners' distributive shares of the firm's income were net earnings from self-employment. Tax Court agreed, stating that legislative history does not support excluding partners who perform services for a partnership from liability for self-employment taxes. (*Renkemeyer*, 136 T.C. No. 7)

Passive activity losses. Tax Court has ruled that the holder of an LLC or LLP interest is not treated as a limited partner for purposes of applying the material participation tests for passive activities when he or she has management rights in the entity. (*Garnett*, 132 T.C. No. 19)

Proposed regulations eliminate the current reliance on limited liability for determining whether an activity is passive under IRC section 469 and instead adopt an approach that relies on the individual partner/member's right to participate in the management of the entity. (REG-109369-10)

Special situations. Different rules may apply to special situations, including banks, insurance companies, or nonprofit organizations that are LLCs or own LLCs. Check with the requirements for the state in which the business will be organized. There are special rules for foreign LLCs.

Classification of LLCs

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a partnership, a disregarded entity, or as a corporation.



Default classification. An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes but as a separate entity for purposes of employment tax and certain excise taxes. See *Employment tax and certain excise taxes*, page 20-15.

Elected classification. An LLC with either a single member or multiple members can elect to be taxed as a corporation for federal tax purposes. For information on making the election, see *Entity Classification Election*, page 18-14.

After an LLC has determined its federal tax classification, it can later elect to change that classification. See *Subsequent Elections (Changing Elections)*, page 20-16.

Effective date of election. Generally, an election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed, nor later than 12 months after the date the election is filed. Late election relief may be available in certain circumstances. See *Late election*, page 18-15.

LLCs Classified as Partnerships

An LLC classified as a partnership is subject to the same filing and reporting requirements as a partnership.

Member manager. A member manager is any owner who, alone or together with others, has the continuing authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no elected or designated member managers, each owner is treated as a member manager.

Conversion of partnership into LLC. The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest. The partnership's tax year does not close and the LLC can continue to use the partnership's taxpayer identification number.

The conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess.

Conversion of LLC into a partnership. The above rules apply if an LLC classified as a partnership is converted into a partnership.

Change in membership. If the number of members in an LLC classified as a partnership is reduced to only one member, it becomes an entity disregarded as separate from its owner. [Reg. §301.7701-3(f)(2)]

Corporation treatment elected prior to change in membership. If the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classification as a disregarded entity will not apply.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

If a partnership that becomes as disregarded entity as a result of a decrease in the number of members makes an election to be classified as a corporation, the applicable deemed transactions will apply. See *Subsequent Elections (Changing Elections)*, page 20-16.

LLCs Classified as Disregarded Entities

If an LLC has only one member and does not elect to be treated as a corporation, it is classified as an entity disregarded as separate from its owner. Its income, deductions, gains, losses, and credits are reported on the owner's income tax return. For example, if the owner of the LLC is an individual, the LLC's income and expenses would be reported on the following schedules filed with the owner's Form 1040.

- Schedule C, *Profit or Loss from Business (Sole Proprietorship)*,
- Schedule E, *Supplemental Income and Loss*, or
- Schedule F, *Profit or Loss From Farming*.



Employment tax and certain excise taxes. Employment taxes (Forms 940, 941, etc.) must be reported and paid in the name and EIN of the LLC rather than in the name and EIN of the single-member owner. The single-member LLC is also required to use the LLC's name and EIN to register for certain excise taxes.

Self-employment tax. An individual owner of an LLC treated as a disregarded entity is not an employee of the LLC. The owner is subject to self-employment tax on the net earnings in the same manner as a sole proprietorship.

Change in membership. If a single member LLC classified as a disregarded entity for income tax purposes acquires an additional member, it becomes a partnership. [Reg. §301.7701-3(f)(2)]

Corporation treatment elected prior to change in membership. If the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classification as a partnership will not apply.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

If a disregarded entity that becomes a partnership as a result of an increase in the number of members makes an election to be classified as a corporation, the applicable deemed transactions will apply. See *Subsequent Elections (Changing Elections)*, page 20-16.

LLCs Classified as Corporations

An LLC with either a single member or multiple members can elect to be classified as a corporation rather than as a partnership or disregarded entity. See *Entity Classification Election*, page 18-14. An LLC classified as a corporation is subject to the same filing and reporting requirements as a corporation. The entity may elect to be treated as an S corporation if it otherwise qualifies. An entity electing to be treated as an S corporation by filing a valid Form 2553, *Election by a Small Business Corporation*, does not need to also file Form 8832, *Entity Classification Election*. See *Form 2553, Election by a Small Business Corporation*, page 19-4.

Note: If the LLC elects to be classified as a corporation by filing Form 8832, a copy of the form must be attached to the federal income tax return of each direct and indirect owner of the LLC for the tax year of the owner that includes that date on which the election took effect.

C corporation. If the entity is treated as a C corporation, it is taxed on its taxable income and distributions to members are includible in each member's gross income to the extent of the corporation's earnings and profits (double taxation).

S corporation. If the entity elects to be an S corporation, the corporation is generally not subject to an income tax. The income, deductions, gains, losses, and credits of the corporation pass through to the members.

Conversion of S corporation to LLC. A conversion from an S corporation to an LLC that elects to be taxed as a corporation can qualify as a tax-free reorganization under IRC section 368(a)(1)(F). In a letter ruling, the corporation did not recognize any gain or loss on the deemed exchange, and the basis and holding periods of the assets in the new LLC were the same as in the hands of the S corporation immediately before the exchange. The S corporation status did not terminate as a result of the reorganization because the new LLC retained its S corporation election and continued to meet S corporation requirements under IRC section 1361. (Ltr. Rul. 200528021)

Change in membership. If the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classifications will not apply. The LLC continues to be treated as a corporation.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

LLC vs. S Corporation

Comparison of LLC treated as a partnership with an S corporation.		
	LLC	S Corporation
<i>Ownership</i>	<ul style="list-style-type: none"> • Unlimited number of members. • Non U.S. citizens or residents allowed. • Can be owned by other corporations, partnerships, trusts, or LLCs. 	<ul style="list-style-type: none"> • No more than 100 shareholders. • Shareholders must be U.S. citizens or residents. • Cannot be owned by other corporations, partnerships, trusts, or LLCs.
<i>Class of stock</i>	Different membership classes allowed.	Only one class of stock allowed.
<i>Transfer of ownership</i>	Member approval often required.	Sale of stock allowed. IRS restrictions must be met to retain S status.
<i>Formalities</i>	Recommended: <ul style="list-style-type: none"> • Adopt operating agreement. • Issue membership shares. • Hold and document annual member meetings. 	Required: <ul style="list-style-type: none"> • Adopt bylaws. • Issue stock. • Annual director meetings. • Meeting minutes kept in corporate record book.
<i>Existence</i>	Some states require dissolution date. Events such as death or withdrawal of member can cause LLC to dissolve.	Perpetual.
<i>Income allocation</i>	May decide to distribute income in any method agreed to by members.	Assigned to each shareholder strictly based on share of ownership.
<i>Pass-through losses (subject to at-risk rules and passive activity loss limitations)</i>	Tax basis rules may allow losses to be more easily passed to members. See <i>Partner's Basis In the Partnership (Outside Basis)</i> , page 20-9.	Pass-through losses limited to shareholder's basis in stock plus loans made by shareholder to corporation.
<i>Self-employment taxes</i>	Members subject to SE tax on guaranteed payments and possibly also distributive share of income. See <i>Limited partners vs. LLC members</i> , page 20-14.	Shareholder/employees subject to payroll taxes on wages but not subject to SE tax on distributive share of income.

For more information, see *Business Entity Pros and Cons* chart, page 31-2, *Small Business Edition*.

Subsequent Elections (Changing Elections)

Generally, once an LLC has elected to change its classification, it cannot elect again to change its classification during the 60 months after the effective date of the election. An election by a newly formed LLC that is effective on the date of formation is not considered a change for purposes of this limitation. [Reg. §301.7701-3(c)]

See also *Change in membership*, page 20-15.

Partnership to corporation. An election to change classification from a partnership to a corporation will be treated as if the partnership contributed all of its assets and liabilities to the corporation in exchange for stock and the partnership then immediately liquidated by distributing the stock to its partners. See *Partnership Distributions*, page 20-11, and *Capital Contributions*, page 18-4.

Corporation to partnership. An election to change classification from a corporation to a partnership will be treated as if the corporation distributed all of its assets and liabilities to its shareholders

in liquidation and the shareholders then immediately contributed all the distributed assets and liabilities to a new partnership. See *Contribution of property*, page 20-9, and *Distributions to Shareholders*, page 18-12.

Corporation to disregarded entity. An election to change classification from a corporation to a disregarded entity will be treated as if the corporation distributed all of its assets and liabilities to its single owner in liquidation. See *Distributions to Shareholders*, page 18-13.

Disregarded entity to corporation. An election to change classification from a disregarded entity to a corporation will be treated as if the owner of the disregarded entity contributed all of the assets and liabilities to the corporation in exchange for stock. See *Capital Contributions*, page 18-4.

Conversion of single-member LLC to multiple-member LLC. A single-member LLC is a “disregarded entity” (a sole proprietorship in the case of a single owner that is an individual) assuming it has not made the election to be taxed as a corporation. If the single-member LLC brings on a new member, the entity ceases to be a disregarded entity and a partnership is created for federal tax purposes. Treatment of the conversion depends on whether the new owner pays the old owner for a portion of his or her interest in the LLC or makes a payment to the LLC in exchange for an interest. (Rev. Rul. 99-5)



New owner pays old owner for an interest in the LLC. The new owner's purchase of the old owner's interest in the LLC is treated as the purchase of an interest in each of the LLC's assets. Immediately thereafter, both owners are treated as having contributed their respective interest in those assets to a partnership in exchange for ownership interests in the partnership. The old owner recognizes gain or loss from the deemed sale of the interest in the assets to the new owner.

New owner makes a contribution to the LLC in exchange for an ownership interest. The old owner is considered to have contributed all the assets to the partnership in exchange for a partnership interest. No gain or loss is recognized by either party as a result of the conversion. The new owner's interest in the partnership is equal to the amount contributed. The old owner's interest in the partnership is the adjusted basis of the assets considered to have been contributed to the new partnership.

Conversion of multiple-member LLC to single-member LLC. When a single person purchases all the ownership interests in an LLC that is taxed as a partnership for federal tax purposes, the LLC becomes a “disregarded entity” (a sole proprietorship in the case of an individual). Treatment of the conversion depends on whether the ownership interests are sold to a purchaser who is a member of the LLC, or the interests are sold to a purchaser who is an unrelated party. (Rev. Rul. 99-6)

Owner sells entire interest in LLC to other owner. The partnership terminates. The selling partner must treat the transaction as the sale of a partnership interest and must report gain or loss, if any, resulting from the sale of a partnership interest. For tax treatment of the purchasing partner, the partnership is deemed to have made a liquidating distribution of all its assets to the partners, and following the distribution, the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner.

Outside party buys the LLC. The partnership terminates. The selling partners must report gain or loss, if any, resulting from the sale of their partnership interests. The partnership is deemed to have made a liquidating distribution of its assets to the partners. Immediately following the distribution, the new owner is deemed to acquire, by purchase, all the former partnership's assets.

Limited Liability Partnerships (LLPs)

Limited liability partnerships are entities formed under state law. The purpose of an LLP is generally to offer a degree of liability protection for professionals, such as doctors and lawyers, who wish to operate as partnerships. Typically, state LLP provisions will allow formation of a partnership but will shield a partner from liability for negligence or malpractice generated by another member of the partnership. Most states require some level of liability insurance to be maintained by LLPs.

For federal tax purposes, if the LLP does not make an election to be taxed as a corporation, the LLP is treated as a partnership, and as such, files Form 1065. An LLP is eligible to elect to be taxed as a corporation by filing Form 8832, *Entity Classification Election*. See *Check the Box Rules—Entity Classification Election*, page 18-14.

Publicly Traded Partnership (PTPs)

Cross References

- IRC § 7704, *Certain publicly traded partnerships treated as corporations*
- Notice 88-75

Related Topics

- Passive Activity Losses, page 7-9, *1040 Edition/Deluxe Edition*
- Partners, LLC Members, Corporation Shareholders, page 7-12, *1040 Edition/Deluxe Edition*
- C Corporations, Tab 18



Certain publicly traded partnerships are treated as corporations. For purposes of this rule, a publicly traded partnership means any partnership if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or a substantial equivalent). [IRC §7704(b)]

A PTP will not be treated as a corporation if at least 90% of its income is qualifying income. Qualifying income includes:

- Interest.
- Dividends.
- Real estate rental.
- Gain from the sale of real estate.
- Certain partnership income from the sale of commodities and futures.
- Gain from the sale of a capital asset held for the production of income.



Effect of becoming a corporation. As of the first day that a partnership is treated as a corporation, the partnership shall be treated as:

- Transferring all its assets (subject to its liabilities) to a newly formed corporation in exchange for the stock of the corporation, and
- Distributing such stock to its partners in liquidation of their interests in the partnership.

Electing 1987 partnerships. Internal Revenue Code section 7704 was enacted in 1987. At that time, a 10-year exemption from PTP rules was allowed for an existing partnership that made the election. The 10-year exemption was scheduled to expire on December 31, 1997. However, the Taxpayer Relief Act of 1997 allowed such grandfathered partnerships to retain their exemption—at a price. Publicly traded partnerships that wish to maintain the election must pay a premium of 3.5% of gross income annually.

Partnership Example

Greener Pastures Partnership. This example is part of a series that follows the business cycle of “Greener Pastures” from concept to inception, start-up to the end of the first tax year, then through completion of the tax return and reporting income to owners. The example illustrates how business transactions are reported for a partnership, and includes books, financial statements, and line-by-line illustrations of how to complete Form 1065, *U.S. Return of Partnership Income*.

Compare this example to the corresponding examples for C corporations in Tab 18 and S corporations in Tab 19.

Principles of partnership taxation. For federal tax purposes, a partnership is a pass-through entity. Partnership income and deductions are reported on Form 1065, then passed through to partners on Schedule K-1. Partners pay tax on income as it is earned, whether or not the income is distributed. Subsequent distributions of cash or property to partners are generally not taxable. See *Fundamentals of Partnership Taxation*, page 20-5, and *Partnership Distributions*, page 20-11, for more information.

Scenario

Nate owned a lawn and garden implement store. Tyler owned a hydroseeding business. Nate and Tyler decided to go into business together under the name “Greener Pastures.”

Creation of the partnership. After consulting with an attorney for advice about the choice of business entity, Nate and Tyler decided to form a partnership. In their state, no special filings are required to form a partnership. The attorney assisted in drafting a partnership agreement. See *Partnership Agreement*, below.

- The attorney’s fee was \$2,000.

Tax advice. The tax consultant for Greener Pastures Partnership obtained an employer identification number (EIN) for the business (see page 5-1, *1040 Edition/Deluxe Edition*, for information about obtaining an EIN). The tax consultant then instructed the partners to open a business checking account and to make cash contributions to capital.

- The tax consultant’s fee was \$2,500.

Business start date. Greener Pastures Partnership opened for business on April 1, 2015.

Partnership Agreement

Although a verbal agreement is all that is required to establish a partnership for federal tax purposes, a partnership should be formed under a written agreement. Tax treatment of certain items can be affected by the presence and content of a partnership agreement. For example, if a partner pays partnership expenses out-of-pocket, the partner cannot deduct those expenses against partnership income unless the partnership agreement requires payment of such expenses. Allowable unreimbursed expenses paid by a partner not only reduce income, but also reduce a partner’s income subject to self-employment tax. See *Unreimbursed Partnership Expenses*, page 20-8.

Also, any special allocations to partners must be made under the partnership agreement. If no allocations are made, all partners’ distributive shares of income and deductions are passed through based on each partner’s percentage of ownership interest. See *Distributive Share*, page 20-6.

Capital contributions. Nate makes an initial capital contribution in the amount of \$55,000. Tyler makes an initial capital contribution in the amount of \$45,000. The partners’ distributive shares of income and deductions will be allocated based on the ratio of capital contributions. Nate’s distributive share will be 55%. Tyler’s distributive share will be 45%.

Employee benefits. The partnership will pay premiums of \$1,800 for each partner and employee, which is 100% of the cost of their high-deductible medical insurance purchased through a Small Business Health Options Program (SHOP) Marketplace. It will also contribute to both HSA and SIMPLE plans for each partner and employee.

Health savings accounts. The partnership will contribute \$3,350 to an HSA for each individual. See *Line 19, Employee benefit programs*, page 20-21, for how to report on Form 1065. See also *Health Savings Accounts*, Tab 13, 1040 Edition/Deluxe Edition, for more information about HSAs.

SIMPLE plan. The partnership will contribute to Savings Incentive Match Plans for Employees (SIMPLE plans) by means of establishing SIMPLE IRAs. The partnership will match employee elective deferrals dollar-for-dollar up to 3% of each employee's wages.

Note: The SIMPLE payments made on behalf of the partners will be reflected on the partners' Schedule K-1. Nate will make elective deferrals of \$5,500 and Tyler will make elective deferrals of \$4,500. See *SIMPLE matching contributions*, page 20-22, for computation of employer's matching contributions for partners.

Guaranteed payments. Nate's guaranteed payment base is \$55,755; Tyler's guaranteed payment base is \$44,245. The partnership will also make payments for health insurance, contributions to HSAs, and SIMPLE matching payments on behalf of the partners.



Note: For purposes of this example, guaranteed payments will be reduced by the amount of SIMPLE elective contributions made on behalf of the partners so this example will more closely correspond to the C corporation and S corporation examples in Tab 18 and Tab 19. The SIMPLE contributions for partners' elective deferrals and matching amounts are reported as separately stated items on line 13, Schedule K (Form 1065). Guaranteed payments of \$100,300 reported on the tax return break down as follows.

	Nate	Tyler
Base guaranteed payment.....	\$55,755	\$44,245
Health insurance.....	\$ 1,800	\$ 1,800
HSA contribution.....	\$ 3,350	\$ 3,350
SIMPLE elective deferrals.....	(\$ 5,500)	(\$ 4,500)
Total guaranteed payments.....	\$55,405	\$44,895

Partners' unreimbursed partnership expenses. The partners in Greener Pastures Partnership are responsible for paying their own professional publications, association dues, and sanctioning fees. The partners will deduct those expenses on page 2, Schedule E (Form 1040). Compare the same expenses paid by C corporation shareholders in Tab 18 and S corporation shareholders in Tab 19, which are deductible as itemized deductions subject to the 2% AGI limit and do not reduce employment taxes. See *Unreimbursed Partnership Expenses*, page 20-8.

In this example, Nate has incurred unreimbursed partnership expenses (UPE) of \$660 and Tyler has UPE of \$540.

Tax year. The partnership adopts a calendar tax year. The first tax year is a short tax year beginning on April 1 and ending on December 31. The partnership will establish its calendar tax year with the IRS when it files its first income tax return. See *Accounting Periods and Methods*, page 8-21, 1040 Edition/Deluxe Edition, for more information about a short tax year, and *Short Tax Year Depreciation*, page 9-5, 1040 Edition/Deluxe Edition.

Accounting method. The partnership will use the cash method of accounting.



Note: The partnership will hold inventory consisting of lawn and garden implements and hydroseeding materials. Under the general rule, if a company carries inventory, the accrual method of

accounting must be used for purchases and sales. However, businesses with average gross receipts of \$1 million or less are eligible to use the cash method of accounting. Even though Greener Pastures Partnership will use the cash method of accounting, the cost of inventory cannot be deducted until the products are sold. See *Inventory/Cost of Goods Sold*, page 8-14, 1040 Edition/Deluxe Edition, for more information about accounting for inventory.

Organizational Costs and Start-Up Costs

The attorney's fee of \$2,000 and the tax consultant's fee of \$2,500 are organizational costs. The travel expenses of \$1,660 were incurred visiting prospective suppliers in advance of the business start date of April 1, 2015. Because they were incurred before the business started operating, they are classified as start-up costs.

Organizational costs and start-up costs are capital expenses. An election is available to deduct up to \$5,000 in organization costs and \$5,000 in start-up costs for tax purposes. Amortization is available for amounts in excess of the limits. Greener Pastures Partnership will elect to deduct its organizational costs and start-up costs for tax year 2015. See *Start-Up Costs and Organizational Costs*, page 20-6.

Purchase of Assets

Greener Pastures Partnership took out a bank loan of \$23,600 to purchase equipment for hydroseeding. It paid cash for display shelving, office furniture, and computers totaling \$16,515.

Equipment.....	\$23,600
Display shelving.....	8,950
Office furniture.....	3,675
Computers.....	3,890
Total.....	\$40,115

Section 179 deduction and depreciation. A Section 179 deduction of up to \$25,000 is available for tax year 2015. Greener Pastures Partnership elects to claim a Section 179 deduction for the hydroseeding equipment only. The remaining assets will be depreciated for tax purposes under regular MACRS using a short tax year.

Note that the Section 179 deduction is not taken as an expense against taxable income on Form 1065. For a partnership, any amount claimed as a Section 179 deduction is passed through to the partners as a separately stated item on Schedule K-1. The partners in this example will deduct the Section 179 expense on page 2, Schedule E (Form 1040).

Short tax year depreciation. Since the partnership's first year is less than 12 months, depreciation cannot be computed using the MACRS percentage tables. See *Short Tax Year Depreciation*, page 9-5, 1040 Edition/Deluxe Edition. See *2015 Depreciation Schedule—Greener Pastures, Inc.*, page 20-19.

Payroll

Employees. Greener Pastures Partnership hired Evan to assist Tyler with hydroseeding, Cyndi as an assistant store manager, and Tristan and Jordan as sales people. In addition to wages, the partnership will provide health benefits through HSAs and retirement benefits through a SIMPLE plan. See *Payroll Report for Year Ended December 31, 2015*, page 20-19.

Distributions

In December 2015, Greener Pastures Partnership made cash distributions of \$5,500 to Nate and \$4,500 to Tyler.



Financial Statements

The balance sheet and income statement for the short year ended December 31, 2015, along with the depreciation schedule and payroll report for Greener Pastures Partnership can be found

continued on page 20-20

Payroll Report for Year Ended December 31, 2015

Employee	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	SIMPLE Elective Deferrals	Net Pay
Evan	\$31,200.00	\$1,934.40	\$ 452.40	\$ 3,912.00	\$1,632.00	\$ 3,120.00	\$20,149.20
Cyndi	\$26,000.00	\$1,612.00	\$ 377.00	\$ 3,120.00	\$1,272.00	\$ 2,600.00	\$17,019.00
Tristan	\$20,800.00	\$1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00	\$ 2,080.00	\$13,804.80
Jordan	\$20,800.00	\$1,289.60	\$ 301.60	\$ 2,328.00	\$ 996.00	\$ 2,080.00	\$13,804.80
Totals	\$98,800.00	\$6,125.60	\$1,432.60	\$11,688.00	\$4,896.00	\$ 9,880.00	\$64,777.80

Final Pay Period—Taxes Deposited January 2016

	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	SIMPLE Elective Deferrals	Net Pay
	\$ 1,900.00	\$ 117.80	\$ 27.55	\$ 224.77	\$ 94.15	\$ 190.00	\$ 1,245.73

2015 Depreciation Schedule—Greener Pastures Partnership

Asset	Placed in Service	Basis	Section 179	Depreciable Basis	Recovery Period	Method
Equipment	April 1, 2015	\$23,600.00	\$23,600.00	\$ 0.00	7 yr.	200DB
Display shelving	April 1, 2015	\$ 8,950.00	\$ 0.00	\$ 8,950.00	7 yr.	200DB
Office furniture	April 1, 2015	\$ 3,675.00	\$ 0.00	\$ 3,675.00	7 yr.	200DB
Computers	April 1, 2015	\$ 3,890.00	\$ 0.00	\$ 3,890.00	5 yr.	200DB
Totals		\$40,115.00	\$23,600.00	\$16,515.00		

Regular Tax Depreciation—Short Tax Year 200DB

Display shelving.....	$\$8,950 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 959$
Office furniture.....	$\$3,675 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 394$
Computers.....	$\$3,890 \times \frac{1}{5} \times 200\% \times \frac{4.5}{12} = \$ 584$
Total regular tax depreciation.....	\$1,937

AMT—Short Tax Year 150DB. Refigure depreciation for AMT purposes for property depreciated using the 200% DB method by using the 150% DB method with the same convention and recovery period. Costs recovered under Section 179 do not need to be added back for AMT.

Display shelving.....	$\$8,950 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 719$
Office furniture.....	$\$3,675 \times \frac{1}{7} \times 150\% \times \frac{4.5}{12} = \$ 295$
Computers.....	$\$3,890 \times \frac{1}{5} \times 150\% \times \frac{4.5}{12} = \$ 438$
Total AMT depreciation.....	\$1,452

AMT depreciation adjustment: \$1,937 – \$1,452 = \$485

Balance Sheet—Greener Pastures Partnership

December 31, 2015

Assets:

Cash.....	\$163,359.97
Inventory.....	9,100.00
Equipment.....	23,600.00
Display shelving.....	8,950.00
Office furniture.....	3,675.00
Computers.....	3,890.00
Accumulated depreciation.....	(25,537.00)
Total assets.....	\$187,037.97

Liabilities:

Payroll withholding payable.....	\$ 464.27
Sales tax payable.....	1,234.64
SIMPLE employee deferrals payable.....	190.00
SIMPLE partners' elective deferrals & match..	14,914.15
Loan payable.....	20,459.27
Total liabilities.....	\$ 37,262.33

Equity:

Capital contributions.....	\$100,000.00
Current earnings.....	59,775.64
Distributions.....	(10,000.00)
Total equity.....	\$149,775.64
Total liabilities plus equity.....	\$187,037.97

Income Statement—Greener Pastures Partnership

Year ended December 31, 2015

Revenue:

Lawn and garden implement sales.....	\$215,500.00
Hydroseeding services.....	212,450.00
Interest earned.....	566.00
Gross income.....	\$428,516.00

Cost of goods sold:

Beginning inventory.....	\$ 0.00
Purchases.....	74,025.00
Ending inventory.....	(9,100.00)
Cost of goods sold.....	\$ 64,925.00
Gross profit.....	\$363,591.00

Expenses:

Accounting (organizational costs).....	\$ 2,500.00
Advertising.....	3,000.00
Attorney fees (organizational costs).....	2,000.00
Bookkeeping.....	2,800.00
Depreciation.....	25,537.00
Employee benefit programs	
HSA contributions.....	13,400.00
Health insurance.....	7,200.00
SIMPLE employer match.....	2,964.00
SIMPLE partners' elective deferrals.....	10,000.00
SIMPLE partners' employer match.....	4,914.15
Guaranteed payments.....	100,300.00
Insurance—business.....	3,250.00
Interest expense.....	916.36
Meals and entertainment.....	1,100.00
Office expenses.....	2,325.00
Payroll taxes.....	9,298.85
Rent.....	9,000.00
Travel and lodging (start-up costs).....	1,660.00
Utilities.....	2,850.00
Wages.....	98,800.00
Total expenses.....	\$303,815.36
Net income per books.....	\$ 59,775.64

Cash Flow Reconciliation

Business Name: Greener Pastures Partnership **Period:** 4/1/15 to 12/31/15 **EIN:** 31-2345678

1) Starting cash balance	1)	0.00
Cash In		
2) Customer receipts: categories		
Lawn and garden implement sales		215,500.00
Hydroseeding services		212,450.00
Sales tax collected		14,815.63
Total customer receipts	2)	442,765.63
3) Investment income: interest, dividends, etc.		
Interest income		566.00
Total investment income	3)	566.00
4) Cash received from accounts receivable not listed elsewhere	4)	
5) Cash received from sale of assets	5)	
6) Cash received from loan repayments	6)	
7) Cash received from loan proceeds	7)	
8) Contributions to capital	8)	100,000.00
9) Other receipts	9)	
Total starting cash balance plus cash in		<u>543,331.63</u>
Cash Out		
10) Business expenses: categories		
Accounting (organization costs)		2,500.00
Advertising		3,000.00
Attorney fees (organization costs)		2,000.00
Bookkeeping		2,800.00
Employee benefit programs:		
HSA contributions		13,400.00
Health insurance		7,200.00
SIMPLE plan employer match		2,964.00
SIMPLE plan employee elective deferrals		9,690.00
Guaranteed payments (includes \$6,700 HSA contributions & \$3,600 medical insurance for partners)		100,300.00
Insurance—business		3,250.00
Meals and entertainment		1,100.00
Office expenses		2,325.00
Payroll taxes:		
Federal unemployment (FUTA)		168.00
Federal quarterly (Form 941)		26,288.93
State unemployment		1,718.00
State withholding		4,801.85
Rent		9,000.00
Sales tax		13,580.99
Travel (start-up costs)		1,660.00
Utilities		2,850.00
Wages/net		64,777.80
Total business expenses	10)	275,374.57
11) Purchases of inventory	11)	74,025.00
12) Loans payable		
Asset Equipment		
Principal 3,140.73 Interest 916.36 = Total		4,057.09
Total loans payable	12)	4,057.09
13) Paid on accounts payable	13)	
14) Cash disbursements on loans receivable	14)	
15) Cash distributions to owners	15)	10,000.00
16) Cash paid for asset purchases	16)	16,515.00
17) Other cash out	17)	
Total cash out for period		<u>379,971.66</u>
Ending cash balance		<u>163,359.97</u>

on page 20-19. A cash flow reconciliation statement for the short year is found in the column to the left.

Line-by-Line Explanations (Form 1065)



Heading information:

Item C. Principal business activity codes, see page 24-2.

Item D. See page 5-1, 1040 Edition/Deluxe Edition, to apply for an EIN.

Item F. Enter the partnership's total assets at the end of the tax year. If there are no assets at the end of the tax year, enter -0-. If the partnership is required to complete Schedule L, total assets from Schedule L, line 14, column (d) should match page 1, item F.

Item G. If a partnership is terminated because of a sale or exchange of 50% or more of the interests in partnership capital and profits within a 12-month period, check box G(2) and box G(6). See *Terminating a Partnership*, page 20-14.

Income

Line 1. Gross receipts or sales. Enter gross receipts or sales from all trade or business operations except those entered on lines 4 through 7.

In this example, lawn and garden implement sales of \$215,500 and hydroseeding sales of \$212,450 add up to \$427,950 total sales.



Line 2. Cost of goods sold (COGS). The COGS is computed on Form 1125-A, *Cost of Goods Sold*, and carried to line 2.

In this example, COGS equals \$64,925.


Deductions

Line 9. Salaries and wages. Enter salaries and wages paid to non-partners, reduced by certain employment-related credits.

Do not include salaries and wages reported elsewhere on Form 1065, such as guaranteed payments to partners, amounts included in COGS, or elective contributions made under a 401(k) plan, a SEP agreement, or a SIMPLE IRA plan.

In this example, gross employee wages of \$98,800 are reduced by elective SIMPLE contributions of \$9,800 and a Credit for Small Employer Health Insurance Premiums of \$3,600 for a total of \$85,320. For an example of how to calculate the credit, see *Credit for Small Employer Health Insurance Premiums*, page 30-15, *Small Business Edition*.

Line 10. Guaranteed payments to partners. Report payments to partners for services or for use of capital if the payments or credits are determined without regard to partnership income and are allocable to a trade or business. Also include amounts

Form 1065 Department of the Treasury Internal Revenue Service		U.S. Return of Partnership Income For calendar year 2015, or tax year beginning <u>4/1, 2015</u> , ending <u>12/31, 2015</u> ▶ Information about Form 1065 and its separate instructions is at www.irs.gov/form1065 .		OMB No. 1545-0123 2015	
A Principal business activity Retail Sales		Name of partnership Greener Pastures Partnership		D Employer identification number 31-2345678	
B Principal product or service Lawn & Garden Supplies		Type or Print 123 Prairie Point		E Date business started 4/1/15	
C Business code number 444200		City or town, state or province, country, and ZIP or foreign postal code Farmdale, MN 55555		F Total assets (see the instructions) \$ 187,038	
G Check applicable boxes: (1) <input checked="" type="checkbox"/> Initial return (2) <input type="checkbox"/> Final return (3) <input type="checkbox"/> Name change (4) <input type="checkbox"/> Address change (5) <input type="checkbox"/> Amended return (6) <input type="checkbox"/> Technical termination - also check (1) or (2)					
H Check accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual (3) <input type="checkbox"/> Other (specify) ▶					
I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ 2					
J Check if Schedules C and M-3 are attached <input type="checkbox"/>					
Caution. Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.					
Income	1a	Gross receipts or sales	1a	427,950	
	b	Returns and allowances	1b		
	c	Balance. Subtract line 1b from line 1a	1c	427,950	
	2	Cost of goods sold (attach Form 1125-A)	2	64,925	
	3	Gross profit. Subtract line 2 from line 1c	3	363,025	
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)	4		
	5	Net farm profit (loss) (attach Schedule F (Form 1040))	5		
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)	6		
Deductions <small>(see the instructions for limitations)</small>	7	Other income (loss) (attach statement)	7		
	8	Total income (loss). Combine lines 3 through 7	8	363,025	
	9	Salaries and wages (other than to partners) (less employment credits)	9	85,320	
	10	Guaranteed payments to partners	10	100,300	
	11	Repairs and maintenance	11		
	12	Bad debts	12		
	13	Rent	13	9,000	
	14	Taxes and licenses	14	9,299	
	15	Interest	15	916	
	16a	Depreciation (if required, attach Form 4562)	16a	1,937	
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		
	17	Depletion (Do not deduct oil and gas depletion.)	17	1,937	
	18	Retirement plans, etc.	18	12,844	
	19	Employee benefit programs	19	20,600	
20	Other deductions (attach statement)	20	20,935		
21	Total deductions. Add the amounts shown in the far right column for lines 9 through 20.	21	261,151		
22	Ordinary business income (loss). Subtract line 21 from line 8	22	101,874		
Sign Here Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than general partner or limited liability company member manager) is based on all information of which preparer has any knowledge.					
Print/Type preparer's name Nate		Preparer's signature 		Date _____	
May the IRS discuss this return with the preparer shown below (see instructions)? <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No					
Paid Preparer Use Only Firm's name ▶ Firm's address ▶		Firm's EIN ▶ Phone no.		Check <input type="checkbox"/> if self-employed PTIN	
For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11390Z Form 1065 (2015)					

paid for medical insurance for a partner, partner's spouse, partner's dependents, or partner's children under age 27 who are not dependents.

In this example, guaranteed payments to partners total \$100,300. See *Guaranteed payments*, page 20-18, for a breakdown used in this example. Also see *Guaranteed Payments*, page 20-6, for more information.

Line 13. Rent. Enter rent paid on business property used in a trade or business activity.

In this example, the partnership paid \$9,000 during the year for facility rental.

Line 14. Taxes and licenses. Enter the taxes and licenses paid or incurred in the trade or business of the partnership.

In this example, taxes of \$9,299 (rounded) consists of employer Social Security tax of \$6,007.80 (6.2% of gross wages = \$6,125.60 less \$117.80 payable in 2016), employer Medicare tax of \$1,405.05 (\$1,432.60 less \$27.55 payable in 2016), FUTA of \$168, and state unemployment taxes of \$1,718.

Line 15. Interest. Include only interest incurred in the partnership's trade or business activities that is not claimed elsewhere on the return.

In this example, \$916 interest was paid on the loan for the hydroseeding equipment.

Line 16. Depreciation. Enter only the depreciation claimed on assets used in a trade or business activity. Complete Form 4562 only if the partnership placed property in service during the tax year or claims depreciation on any car or other listed property.

Do not include any Section 179 expense on this line. Section 179 expense is not deducted by the partnership and is a separately stated item passed through to partners in box 12, Schedule K-1.

In this example, the depreciation deducted by the partnership after considering the Section 179 expense was \$1,937. A Section 179 deduction in the amount of \$23,600 was allocated and passed through to partners on Schedule K-1. See *2015 Depreciation Schedule—Greener Pastures, Inc.*, page 20-19.

Line 18. Retirement plans, etc. Do not deduct payments for partners to retirement or deferred compensation plans. These amounts are instead reported in box 13, Schedule K-1, using Code R, and are deducted by the partners on their own returns.

Enter the deductible contribution not claimed elsewhere on the return made by the partnership for its common-law employees.

In this example, \$12,844 consists of SIMPLE plan employee elective deferrals of \$9,880 and employer matching contributions of \$2,964.

Line 19. Employee benefit programs. Do not include amounts paid during the tax year for medical insurance for a partner, partner's spouse, or partner's dependents. Include such payments as guaranteed payments and report on Schedule K-1.

In this example, the employee benefit programs deduction of \$20,600 includes \$7,200 paid for health insurance for the employees, and \$13,400 in contributions made to the employees' HSAs.

Line 20. Other deductions. Enter the total allowable trade or business deductions not listed on other lines on Form 1065. Attach a statement listing the type and amount.

Following is a statement of other deductions for this example.

**Statement of Other Deductions—
Line 20, Form 1065**

Accounting (organization costs)	\$2,500
Advertising	\$3,000
Attorney fees (organization costs)	\$2,000
Bookkeeping	\$2,800
Insurance-business	\$3,250
Meals and entertainment (1,100 × 50%)	\$550
Office expenses	\$2,325
Travel and lodging (start-up costs)	\$1,660
Utilities	\$2,850
Total other deductions	\$20,935

Schedules K and K-1 (Form 1065)

Schedule K. Schedule K is a summary schedule of all partners' shares of the partnership's income, credits, deductions, etc. Since rental activity income or loss and portfolio income are not reported on page 1, Form 1065, Schedule K is used to report these and other amounts.

In this example, the following items are reported Schedule K.

- Line 1, Ordinary business income, \$101,874.
- Line 4, Guaranteed payments, \$100,300.
- Line 5, Interest income, \$566.
- Line 12, Section 179 deduction, \$23,600.
- Line 13d, Other deductions, includes partners' HSA contributions of \$6,700,

partners' health insurance of \$3,600, partners' SIMPLE elective deferrals of \$10,000, and partners' SIMPLE matching contributions of \$4,914, for a total of \$25,214. See *SIMPLE matching contributions*, below.

- Line 14a, Net earnings from self-employment includes \$101,874 ordinary income plus \$100,300 guaranteed payments for a total of \$202,174.
- Line 14c, Gross nonfarm income, \$363,025.
- Line 15f, code P, Credit for Small Employer Health Insurance Premiums, \$3,600.
- Line 17a, AMT depreciation adjustment, \$485. See *Depreciation Schedule—Greener Pastures Partnership*, page 20-19.
- Line 18c, Nondeductible expenses, \$550.
- Line 19a, Cash distributions of \$10,000.
- Line 20a, Investment income, \$566.

Schedule K-1. Schedule K-1 shows each partner's separate share of items from Schedule K. Attach a copy of each Schedule K-1 to Form 1065 filed with the IRS. Also provide the appropriate copy of Schedule K-1 to each partner.

See *Partnership K-1 Codes*, page 7-2, 1040 Edition/Deluxe Edition.

In this example, the following items are reported to Nate on Schedule K-1 for reporting on his individual income tax return.

- Line 1, Share of ordinary business income, \$56,031.
- Line 4, Guaranteed payments, \$55,405. See *Guaranteed payments*, page 20-18.
- Line 5, Share of interest income, \$311.
- Line 12, Share of Section 179 deduction, \$12,980.
- Line 13, code R, SIMPLE elective deferrals of \$5,500 and SIMPLE matching contributions of \$2,709 for a total of \$8,209. See *SIMPLE matching contributions*, below.
- Line 13, code M, Health insurance of \$1,800.
- Line 13, code W, HSA contribution of \$3,350.
- Line 14, code A, Self-employment earnings includes \$56,031 ordinary income plus \$55,405 guaranteed payments for a total of \$111,436.
- Line 14, code C, Share of gross income, \$199,664.
- Line 15, code P, Share of Credit for Small Employer Health Insurance Premiums, \$1,980.
- Line 17, code A, Share of AMT depreciation adjustment, \$267.
- Line 18, code C, Share of nondeductible expenses, \$303.
- Line 19, code A, Distributions of \$5,500.
- Line 20, code A, Share of investment income, \$311.

SIMPLE matching contributions. For SIMPLE plans, net earnings from self-employment is the amount on line 4,

Schedule K		Partners' Distributive Share Items		Total amount	
Income (Loss)	1	Ordinary business income (loss) (page 1, line 22)		1	101,874
	2	Net rental real estate income (loss) (attach Form 8825)		2	
	3a	Other gross rental income (loss)	3a		
	b	Expenses from other rental activities (attach statement)	3b		
	c	Other net rental income (loss). Subtract line 3b from line 3a		3c	
	4	Guaranteed payments		4	100,300
	5	Interest income		5	566
	6	Dividends: a Ordinary dividends b Qualified dividends	6b	6a	
	7	Royalties		7	
	8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))		8	
	9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))		9a	
b	Collectibles (28%) gain (loss)	9b			
c	Unrecaptured section 1250 gain (attach statement)	9c			
10	Net section 1231 gain (loss) (attach Form 4797)		10		
11	Other income (loss) (see instructions) Type ▶		11		
Deductions	12	Section 179 deduction (attach Form 4562)	Partners: HSA \$ 6,700	12	23,600
	13a	Contributions	Health insurance \$ 3,600	13a	
	b	Investment interest expense	SIMPLE contributions... \$14,914	13b	
	c	Section 59(e)(2) expenditures: (1) Type ▶ (2) Amount ▶		13c(2)	
d	Other deductions (see instructions) Type ▶		13d	25,214	
Self-Employment	14a	Net earnings (loss) from self-employment	Ordinary income \$101,874	14a	202,174
	b	Gross farming or fishing income	Guaranteed payments..... \$100,300	14b	
	c	Gross nonfarm income		14c	363,025
Credits	15a	Low-income housing credit (section 42(j)(5))		15a	
	b	Low-income housing credit (other)		15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)		15c	
	d	Other rental real estate credits (see instructions) Type ▶		15d	
	e	Other rental credits (see instructions) Type ▶		15e	
	f	Other credits (see instructions) Type ▶	P - Credit for Small Employer Health Insurance Premiums	15f	3,600
Foreign Transactions	16a	Name of country or U.S. possession ▶		16a	
	b	Gross income from all sources		16b	
	c	Gross income sourced at partner level		16c	
	d	Foreign gross income sourced at partnership level			
	e	Passive category ▶	f Other ▶	16f	
	g	Deductions allocated and apportioned at partner level			
	h	Interest expense ▶	i Other ▶	16h	
	j	Deductions allocated and apportioned at partnership level to foreign source income			
	k	Passive category ▶	l General category ▶	16k	
	m	Total foreign taxes (check one): ▶ Paid <input type="checkbox"/> Accrued <input type="checkbox"/>		16l	
	n	Reduction in taxes available for credit (attach statement)		16m	
	o	Other foreign tax information (attach statement)			
Alternative Minimum Tax (AMT) Items	17a	Post-1986 depreciation adjustment		17a	485
	b	Adjusted gain or loss		17b	
	c	Depletion (other than oil and gas)		17c	
	d	Oil, gas, and geothermal properties—gross income		17d	
	e	Oil, gas, and geothermal properties—deductions		17e	
	f	Other AMT items (attach statement)		17f	
Other Information	18a	Tax-exempt interest income		18a	
	b	Other tax-exempt income		18b	
	c	Nondeductible expenses		18c	550
	19a	Distributions of cash and marketable securities		19a	10,000
	b	Distributions of other property		19b	
	20a	Investment income		20a	566
b	Investment expenses		20b		
c	Other items and amounts (attach statement)				

Section A, Schedule SE, (Form 1040), *Self-Employment Tax*.

The matching contributions in this example are computed as follows:



	Nate	Tyler
K-1 line 1. Ordinary income.	\$56,031	\$45,843
K-1 line 4. Guaranteed payments.	\$55,405	\$44,895
K-1 line 12. Section 179 expense.	(\$12,980)	(\$10,620)
Partner's unreimbursed expenses.	(\$660)	(\$540)
Total income from self-employment	\$97,796	\$79,578
× 92.35% (line 4, Schedule SE)	\$90,315	\$73,490
3% match	\$2,709	\$2,205

Author's Comment: IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*, states that for purposes of computing SIMPLE plan limits for partners, net earnings from self-employment is the amount from line 4, Part A of the partner's Schedule SE (Form 1040). This amount will often not be correct, such as when there is additional income from other sources of self-employment, such as a different sole proprietorship operated by the individual.

For purposes of this example, the matching contribution was based on self-employment income passing through on Schedule K-1, reduced by the Section 179 deduction and the deduction for unreimbursed partnership expenses. Before the partnership can properly calculate the employer SIMPLE matching contribution, the partner must inform it of any unreimbursed partnership expenses they plan to deduct on their personal return.

Analysis of Net Income (Loss)

1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 16l						1	153,926
2	Analysis by partner type:							
	(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt Organization	(vi) Nominee/Other		
a	General partners	153,926						
b	Limited partners							

Schedule L—Balance Sheets per Books

	Beginning of tax year		End of tax year	
	(a)	(b)	(c)	(d)
Assets				
1	Cash			163,360
2a	Trade notes and accounts receivable			
b	Less allowance for bad debts			
3	Inventories			9,100
4	U.S. government obligations			
5	Tax-exempt securities			
6	Other current assets (attach statement)			
7a	Loans to partners (or persons related to partners)			
b	Mortgage and real estate loans			
8	Other investments (attach statement)			
9a	Buildings and other depreciable assets		40,115	
b	Less accumulated depreciation		25,537	14,578
10a	Depletable assets			
b	Less accumulated depletion			
11	Land (net of any amortization)			
12a	Intangible assets (amortizable only)			
b	Less accumulated amortization			
13	Other assets (attach statement)			
14	Total assets			187,038
Liabilities and Capital				
15	Accounts payable			
16	Mortgages, notes, bonds payable in less than 1 year			
17	Other current liabilities (attach statement)			16,803
18	All nonrecourse loans			
19a	Loans from partners (or persons related to partners)			
b	Mortgages, notes, bonds payable in 1 year or more			20,459
20	Other liabilities (attach statement)			
21	Partners' capital accounts			149,776
22	Total liabilities and capital			187,038

Schedule M-1—Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Note. The partnership may be required to file Schedule M-3 (see instructions).

1	Net income (loss) per books	59,776	6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):	
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):		a	Tax-exempt interest \$	
3	Guaranteed payments (other than health insurance)	90,000	7	Deductions included on Schedule K, lines 1 through 13d, and 16l, not charged against book income this year (itemize):	
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13d, and 16l (itemize):		a	Depreciation \$	
	Salaries and wages	3,600	8	Add lines 6 and 7	
a	Depreciation		9	Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5	153,926
b	Travel and entertainment	550			
5	Add lines 1 through 4	153,926			

Schedule M-2—Analysis of Partners' Capital Accounts

1	Balance at beginning of year	0	6	Distributions: a Cash	10,000
2	Capital contributed: a Cash	100,000	b	Property	
	b Property		7	Other decreases (itemize):	
3	Net income (loss) per books	59,776	8	Add lines 6 and 7	10,000
4	Other increases (itemize):		9	Balance at end of year. Subtract line 8 from line 5	149,776
5	Add lines 1 through 4	159,776			

Schedule M-1—Reconciliation of Income (Loss) per Books With Income (Loss) per Return

Items such as limitations on the deduction for meals and entertainment, separately stated items, and guaranteed payments cause differences between book income and income on the tax return. The amounts are reconciled on Schedule M-1.

For more information, see *Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return*, Tab 27, *Small Business Edition*.

Line 1, Income (loss) per books. In this example, partnership net income is \$59,776 (rounded). See *Income Statement—Greener Pastures Partnership*, page 20-19.

Line 3, Guaranteed payments. Include on this line guaranteed payments other than amounts paid for partners' health insurance.

In this example, guaranteed payments of \$100,300 are reduced by \$3,600 partners' health insurance payments as well as \$6,700 partners' HSA contributions for a total of \$90,000. See *Guaranteed payments*, page 20-18.

Line 4, Expenses recorded on books not included on Schedule K. In this example, include \$3,600 reduction in salaries and wages for the Small Business Health Care Tax Credit and \$550 meal and entertainment expenses in excess of the 50% deduction limitation.

Schedule M-2—Analysis of Partners' Capital Accounts

Schedule M-2 reflects changes to partners' capital accounts that occurred during the year as shown on the partnership's books. The amounts on Schedule M-2 should equal the total of the amounts reported in item L of all the partners' Schedules K-1.

Line 2. Capital contributed during year. Include on line 2a the amount of money contributed, and on line 2b the amount of property contributed by each partner to the partnership as reflected on the partnership's books and records.

In this example, the partners' contributed cash of \$100,000. See *Capital contributions*, page 20-17.

Line 6. Distributions.

Line 6a. Cash. Enter the amount of money or FMV of marketable securities distributed to each partner by the partnership. Marketable securities include financial instruments and foreign currencies which are actively traded.

In this example, the partnership distributed \$10,000 to the partners. See *Distributions*, page 20-18.

Self-employment for LLC members. Had this partnership been taxed as an LLC, a problem arises in determining the SE income of the LLC member for purposes of calculating the employer match for a SIMPLE plan. If the LLC takes the stand that income from line 1, Schedule K-1, is not self-employment income, then the applicable amount for computing the employer match will consist only of guaranteed payments.

See *Separately Stated Items*, page 20-6. Also see *Partnership K-1 Codes*, page 7-2, *1040 Edition/Deluxe Edition*, for reporting items on Schedule K-1.

Schedule L—Balance Sheets per Books

Schedules L, M-1, and M-2 are not required to be completed if the partnership answered "Yes" to question 6, Schedule B (total receipts less than \$250,000, assets

less than \$1,000,000, and Schedules K-1 filed and furnished to partners).

The balance sheets should agree with the partnership's books and records. Attach a statement explaining any differences.

Author's Comment: A partnership that is not required to complete Schedules L, M-1, and M-2 must still maintain adequate books and records for income tax purposes. Completing Schedules L, M-1, and M-2, even when not required, may be beneficial in assuring that the tax return has been prepared properly based on book income.

Line 14. Total assets. Total assets must be determined without offset by liabilities and may not be reported as a negative amount. Generally, total assets at the beginning of the tax year must equal total assets at the close of the prior year. If the amounts do not match, attach a statement explaining the difference.

Form 8941 Credit for Small Employer Health Insurance Premiums OMB No. 1545-2188
 Department of the Treasury Internal Revenue Service **2015** Attachment Sequence No. **65**
 Name(s) shown on return **Greener Pastures Partnership** Identifying number **31-2345678**
 ▶ Attach to your tax return. ▶ Information about Form 8941 and its separate instructions is at www.irs.gov/form8941.

A Did you pay premiums during your tax year for employee health insurance coverage you provided through a Small Business Health Options Program (SHOP) Marketplace (or do you qualify for an exception to this requirement)? (See instructions)
 Yes. Enter Marketplace Identifier (if any): **XXXXXXX**
 No. Stop. Do not file Form 8941 (see instructions for an exception that may apply to a partnership, S corporation, cooperative, estate, or trust).

B Enter the employer identification number (EIN) used to report employment taxes for individuals included on line 1 below if different from the identifying number listed above

Caution: See the instructions and complete Worksheets 1 through 7 as needed.

1	Enter the number of individuals you employed during the tax year who are considered employees for purposes of this credit (total from Worksheet 1, column (a))	4
2	Enter the number of full-time equivalent employees (FTEs) you had for the tax year (from Worksheet 2, line 3). If you entered 25 or more, skip lines 3 through 11 and enter -0- on line 12	4
3	Average annual wages you paid for the tax year (from Worksheet 3, line 3). This amount must be a multiple of \$1,000. If you entered \$52,000 or more, skip lines 4 through 11 and enter -0- on line 12	24,000
4	Premiums you paid during the tax year for employees included on line 1 for health insurance coverage under a qualifying arrangement (total from Worksheet 4, column (b))	7,200
5	Premiums you would have entered on line 4 if the total premium for each employee equaled the average premium for the small group market in which the employee enrolls in health insurance coverage (total from Worksheet 4, column (c))	21,624
6	Enter the smaller of line 4 or line 5	7,200
7	Multiply line 6 by the applicable percentage: • Tax-exempt small employers, multiply line 6 by 35% (0.35) • All other small employers, multiply line 6 by 50% (0.50)	3,600
8	If line 2 is 10 or less, enter the amount from line 7. Otherwise, enter the amount from Worksheet 5, line 6	3,600
9	If line 3 is \$25,000 or less, enter the amount from line 8. Otherwise, enter the amount from Worksheet 6, line 7	3,600
10	Enter the total amount of any state premium subsidies paid and any state tax credits available to you for premiums included on line 4 (see instructions)	0
11	Subtract line 10 from line 4. If zero or less, enter -0-	3,600
12	Enter the smaller of line 9 or line 11	3,600
13	If line 12 is zero, skip lines 13 and 14 and go to line 15. Otherwise, enter the number of employees included on line 1 for whom you paid premiums during the tax year for health insurance coverage under a qualifying arrangement (total from Worksheet 4, column (a))	4
14	Enter the number of FTEs you would have entered on line 2 if you only included employees included on line 13 (from Worksheet 7, line 3)	4
15	Credit for small employer health insurance premiums from partnerships, S corporations, cooperatives, estates, and trusts (see instructions)	0
16	Add lines 12 and 15. Cooperatives, estates, and trusts, go to line 17. Tax-exempt small employers, skip lines 17 and 18 and go to line 19. Partnerships and S corporations, stop here and report this amount on Schedule K-1. All others, stop here and report this amount on Form 3800, Part III, line 4h	3,600
17	Amount allocated to patrons of the cooperative or beneficiaries of the estate or trust (see instructions)	0
18	Cooperatives, estates, and trusts, subtract line 17 from line 16. Stop here and report this amount on Form 3800, Part III, line 4h	0
19	Enter the amount you paid in 2015 for taxes considered payroll taxes for purposes of this credit (see instructions)	0
20	Tax-exempt small employers, enter the smaller of line 16 or line 19 here and on Form 990-T, line 44f	0

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 3775S Form **8941** (2015)

Schedule K-1 (Form 1065) 2015 OMB No. 1545-0123
 Department of the Treasury Internal Revenue Service
 For calendar year 2015, or tax year beginning **4/1, 2015** ending **12/31, 2015**
Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items
 Partner's share of income, deductions, credits, etc. ▶ See back of form and separate instructions.
Part I Information About the Partnership
 A Partnership's employer identification number **31-2345678**
 B Partnership's name, address, city, state, and ZIP code
Greener Pastures Partnership
123 Prairie Point
Farmdale, MN 55555
 C IRS Center where partnership filed return
e-file
 D Check if this is a publicly traded partnership (PTP)
Part II Information About the Partner
 E Partner's identifying number
XXX-XX-XXXX
 F Partner's name, address, city, state, and ZIP code
Nate
 G General partner or LLC member-manager
 Limited partner or other LLC member
 H Domestic partner Foreign partner
 I1 What type of entity is this partner? **Individual**
 I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here
 J Partner's share of profit, loss, and capital (see instructions):

Beginning	Ending
Profit % 55%	Profit % 55%
Loss % 55%	Loss % 55%
Capital % 55%	Capital % 55%

 K Partner's share of liabilities at year end:
 Nonrecourse \$
 Qualified nonrecourse financing \$
 Recourse \$ **11,252**
 L Partner's capital account analysis:
 Beginning capital account \$
 Capital contributed during the year \$ **55,000**
 Current year increase (decrease) \$ **32,877**
 Withdrawals & distributions \$ **(5,500)**
 Ending capital account \$ **82,377**
 Tax basis GAAP Section 704(b) book
 Other (explain)
 M Did the partner contribute property with a built-in gain or loss?
 Yes No
 If "Yes," attach statement (see instructions)
Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)	P	* \$1,980
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)	A	\$267
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)	C	\$303
12	Section 179 deduction	19	Distributions
13	Other deductions	A	\$5,500
R	Other deductions	20	Other information
M	\$1,800	A	\$311
W*	\$3,350	14	Self-employment earnings (loss)
A	\$111,436		
C	\$199,664		

***See attached statement for additional information.**
 For IRS Use Only

For Paperwork Reduction Act Notice, see instructions for Form 1065. IRS.gov/form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2015

Form 1040 (2015)

Tax and Credits

38 Amount from line 37 (adjusted gross income) **77,839**

39a Check You were born before January 2, 1951. Blind. Total boxes
 39b Spouse was born before January 2, 1951. Blind. checked 39a

Standard Deduction

40 If your spouse itemizes on a separate return or you were a dual-status alien, check here 39b
 Subtract line 40 from line 38 **6,300**

41 Single or head of household **71,539**

42 Married filing jointly **4,000**

43 Married filing separately **67,539**

44 Qualifying widow(er) **12,675**

45 Head of household **12,675**

46 Spouse **12,675**

Other Taxes

57 Self-employment tax. Attach Schedule SE **1,980**

58 Unreported social security and Medicare tax from Form: a 4137 b 8919 **58**

59 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required **10,695**

60a Household employment taxes from Schedule H **60a**

60b First-time homebuyer credit repayment. Attach Form 5405 if required **60b**

61 Health care: individual responsibility (see instructions) Full-year coverage **61**

62 Taxes from: a Form 9859 b Form 9860 c Instructions; enter code(s) **62**

63 Add lines 56 through 62. This is your total tax **13,818**

Payments

64 Federal income tax withheld from Forms W-2 and 1099 **64**

65 2015 estimated tax payments and amount applied from 2014 return **65**

66a Earned income credit (EIC) **66a**

66b Nonrefundable tax credit **66b**

67 Additional child tax credit. Attach Schedule 8812 **67**

68 American opportunity credit from Form 8863, line 8 **68**

69 Net premium tax credit. Attach Form 8962 **69**

70 Amount paid with request for extension to file **70**

71 Excess social security and tier 1 RRTA tax withheld **71**

72 Credit for federal tax on fuels. Attach Form 4136 **72**

73 Credits from form: a 2439 b 8865 c 8865 d **73**

74 Add lines 64, 65, 66a, and 67 through 73. These are your total payments **74**

Refund

75 If line 74 is more than line 63, subtract line 63 from line 74. This is the amount you overpaid **75**

76a Amount of line 75 you want refunded to you. If Form 8888 is attached, check here **76a**

Amount You Owe

77 Amount of line 75 you want applied to your 2016 estimated tax **77**

78 Amount you owe. Subtract line 74 from line 63. For details on how to pay, see instructions **78**

Third Party Designee

79 Do you want to allow another person to discuss this return with the IRS (see instructions)? Yes. Complete below. No

Designee's name Personal identification number (PIN)

Phone number

Sign Here

Your signature Date

Spouse's signature Date

Preparer's signature Date

Print/type preparer's name Preparer's occupation

Firm's name Firm's address

Firm's EIN

PTIN

Check if self-employed

Check if self-employed

Daytime phone number

If the IRS sent you an Identity Protection alert, check here (see instructions)

www.irs.gov/form1040 Form 1040 (2015)

Department of the Treasury—Internal Revenue Service (99)

OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

2015 ending .20

1040 U.S. Individual Income Tax Return 2015

Your first name and initial Last name Last name

Your social security number XXX-XX-XXXX

Spouse's social security number XXX-XX-XXXX

If a joint return, spouse's first name and initial Last name

Home address (number and street), if you have a P.O. box, see instructions. Apt. no. _____

City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).

Foreign country name Foreign province/state/county Foreign postal code

Filing Status

1 Single

2 Married filing jointly (even if only one had income)

3 Married filing separately. Enter spouse's SSN above and full name here.

4 Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here.

5 Qualifying widow(er) with dependent child

Exemptions

6a Yourself. If someone can claim you as a dependent, do not check box 6a.

6b Spouse

6c Dependents: (2) Dependent's social security number (3) Dependent's relationship to you (4) If child under age 17, did not live with you due to divorce (see instructions)

(1) First name Last name (1) (2) (3) (4)

d Total number of exemptions claimed **1**

If more than four dependents, see instructions and check here

Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2 **7**

8a Tax-exempt interest. Attach Schedule B if required **8a**

8b Tax-exempt interest. Do not include on line 8a **8b**

9a Ordinary dividends. Attach Schedule B if required **9a**

9b Qualified dividends **9b**

10 Taxable refunds, credits, or offsets of state and local income taxes **10**

11 Alimony received **11**

12 Business income or (loss). Attach Schedule C or C-EZ **12**

13 Capital gain or (loss). Attach Schedule D if required. If not required, check here **13**

14 Other gains or (losses). Attach Form 4797 **14**

15a IRA distributions **15a**

15b Pensions and annuities **15b**

16a Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E **16a**

16b Farm income or (loss). Attach Schedule F **16b**

17 Unemployment compensation **17**

18 Social security benefits **18**

19 Other income. List type and amount **19**

20a **20a**

20b **20b**

21 Combine the amounts in the far right column for lines 7 through 21. This is your total income **21**

22 **22**

23 Reserved **23**

24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ **24**

25 Health savings account deduction. Attach Form 8889 **25**

26 Moving expenses. Attach Form 3903 **26**

27 Deductible part of self-employment tax. Attach Schedule SE **27**

28 Self-employed SEP, SIMPLE, and qualified plans **28**

29 Self-employed health insurance deduction **29**

30 Penalty on early withdrawal of savings **30**

31a Alimony paid **31a**

31b Recipient's SSN **31b**

32 IRA deduction **32**

33 Student loan interest deduction **33**

34 Reserved **34**

35 Domestic production activities deduction. Attach Form 8803 **35**

36 Add lines 23 through 35 **36**

37 Subtract line 36 from line 22. This is your adjusted gross income **37**

Adjusted Gross Income

23 **23**

24 **24**

25 **3,350**

26 **6,909**

27 **8,209**

28 **1,800**

29 **1,800**

30 **31a**

31b **31b**

32 **32**

33 **33**

34 **34**

35 **35**

36 **20,268**

37 **77,839**

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2015)

Schedule E (Form 1040) 2015 Attachment Sequence No. 13 Page 2

Name(s) shown on return: **None** Your social security number: **xxx-xx-xxxx**

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1. **Income or Loss From Partnerships and S Corporations** Note: If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (e) on line 28 and attach Form 6198. See instructions.

Part II Are you reporting any loss not allowed in a prior year due to the at-risk, excess farm loss, or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.

28	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if any amount is not at risk	Nonpassive Income and Loss	
						(f) Passive income from Schedule K-1 (attach Form 6982 if required)	(g) Nonpassive income from Schedule K-1
A	Greener Pastures Partnership	P		31-2345678			111,436
B	UPE (unreimbursed partnership expenses)	P		31-2345678			
C							
D							
29a	Totals					660	111,436
29b	Totals					12,980	111,436
30	Add columns (g) and (i) of line 28a.					30	111,436
31	Add columns (f), (h), and (i) of line 29b.					31	13,640
32	Total partnership and S corporation income or (loss). Combine lines 30 and 31. Enter the result here and include in the total on line 41 below.					32	97,796

SCHEDULE SE (Form 1040) OMB No. 1545-0074

Department of the Treasury Internal Revenue Service (99) **2015** Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040 or Form 1040NR) **xxx-xx-xxxx**

Social security number of person with self-employment income **xxx-xx-xxxx**

Self-Employment Tax

Information about Schedule SE and its separate instructions is at www.irs.gov/schedule/se.

Attach to Form 1040 or Form 1040NR.

2	Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), box 14, code A (other than farming); and Schedule K-1 (Form 1065-B), box 9, code J1. Ministers and members of religious orders, see instructions for types of income to report on this line. See instructions for other income to report.	3	Combine lines 1a, 1b, and 2.	4	Multiply line 3 by 92.35% (.9235). If less than \$400, you do not owe self-employment tax; do not file this schedule unless you have an amount on line 1b.	5	Self-employment tax. If the amount on line 4 is: <ul style="list-style-type: none"> \$118,500 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 57, or Form 1040NR, line 55 More than \$118,500, multiply line 4 by 2.9% (.029). Then, add \$14,694 to the result. Enter the total here and on Form 1040, line 57, or Form 1040NR, line 55. 	6	Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.50). Enter the result here and on Form 1040, line 27, or Form 1040NR, line 27.
		2	97,796	3	97,796	4	90,315	5	13,818
								6	6,909

For Paperwork Reduction Act Notice, see your tax return instructions. Schedule SE (Form 1040) 2015 Cat. No. 11358Z

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Name(s) shown on return: **None** Identifying number: **xxx-xx-xxxx**

Part III General Business Credits or Eligible Small Business Credits (see instructions)

Complete a separate Part III for each box checked below. (see instructions)

A General Business Credit From a Non-Passive Activity E Reserved

B General Business Credit From a Passive Activity F Reserved

C General Business Credit Carryforwards G Eligible Small Business Credit Carryforwards

D General Business Credit Carrybacks H Reserved

I If you are filing more than one Part III with box A, or B checked, complete and attach first an additional Part III combining amounts from all Parts III with box A or B checked. Check here if this is the consolidated Part III.

Note. On any line where the credit is from more than one source, a separate Part III is needed for each pass-through entity.

(a) Description of credit	(b) If claiming the credit from a pass-through entity, enter the EIN	(c) Enter the appropriate amount
1a Investment (Form 3468, Part II only) (attach Form 3468)	1a	
b Reserved	1b	
c Increasing research activities (Form 6765)	1c	
d Low-income housing (Form 8586, Part I only)	1d	
e Disabled access (Form 8826) (see instructions for limitation)	1e	
f Renewable electricity, refined coal, and Indian coal production (Form 8835)	1f	
g Indian employment (Form 8845)	1g	
h Orphan drug (Form 8820)	1h	
i New markets (Form 8874)	1i	
j Small employer pension plan startup costs (Form 8861) (see instructions for limitation)	1j	
k Employer-provided child care facilities and services (Form 8882) (see instructions for limitation)	1k	
l Biodiesel and renewable diesel fuels (attach Form 8864)	1l	
m Low sulfur diesel fuel production (Form 8896)	1m	
n Distilled spirits (Form 8906)	1n	
o Nonconventional source fuel	1o	
p Energy efficient home (Form 8908)	1p	
q Energy efficient appliance	1q	
r Alternative motor vehicle (Form 8910)	1r	
s Alternative fuel vehicle refueling property (Form 8911)	1s	
t Reserved	1t	
u Mine rescue team training (Form 8923)	1u	
v Agricultural chemicals security (carryforward only)	1v	
w Employer differential wage payments (Form 8932)	1w	
x Carbon dioxide sequestration (Form 8933)	1x	
y Qualified plug-in electric drive motor vehicle (Form 8936)	1y	
z Qualified plug-in electric vehicle (carryforward only)	1z	
aa New hire retention (carryforward only)	1aa	
bb General credits from an electing large partnership (Schedule K-1 (Form 1065-B))	1bb	
zc Other	1zc	
2 Add lines 1a through 1zz and enter here and on the applicable line of Part I	2	
3 Enter the amount from Form 8844 here and on the applicable line of Part II.	3	
4a Investment (Form 3468, Part III) (attach Form 3468)	4a	
b Work opportunity (Form 5884)	4b	
c Biofuel producer (Form 6478)	4c	
d Low-income housing (Form 8586, Part II)	4d	
e Renewable electricity, refined coal, and Indian coal production (Form 8835)	4e	
f Employer social security and Medicare taxes paid on certain employee tips (Form 8846)	4f	
g Qualified railroad track maintenance (Form 8900)	4g	
h Small employer health insurance premiums (Form 8941)	4h	31-2345678
i Reserved	4i	
j Reserved	4j	
z Other	4z	
5 Add lines 4a through 4z and enter here and on the applicable line of Part II.	5	1,980
6 Add lines 2, 3, and 5 and enter here and on the applicable line of Part II.	6	1,980

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