A Very Brief Introduction to Partnership Taxation

By R. Samuel Fraundorf, CFA®, CPA

Investors for decades have been drawn to commingled vehicles. Buying power, fees, uniformity of the implementation of ideas, and the speed of the implementation are a few of the reasons. The partnership, in all of its various forms, has proven to be a workhorse for sophisticated investors. Its flexibility and customization, as well as its limited regulatory reporting, has made the limited partnership and its kissing cousin the limited liability company into widely used structures. And taxes, especially in the United States, as its limited regulatory reporting, has made the limited partnership and its kissing cousin the limited liability company into widely used structures. And taxes, especially in the United States, are a large part of the knowledge advisors must grasp in order to help clients.

General Characteristics of Partnerships

A partnership is a business entity in which two or more owners (partners) share the profits and losses of the business. Partnerships tend to come in two flavors: general partnerships and limited partnerships. In a general partnership (GP), all the partners have exposure to the liabilities of the partnership, even if they are in excess of the partners' contributions to the partnership. In a limited partnership (LP), only the managing or general partners have unlimited liability; if the limited partners "limit" their management involvement with the partnership, only their investment is at risk. A limited liability company (LLC) is a state-registered company in which the liability of each member is limited to his investment, regardless of his involvement in management. If the members elect, the LLC can be treated like a partnership for tax purposes.

Additionally, investment partnerships are business entities that allow investors to pool assets in order to make portfolio investments. But these types of partnerships are not in the investment business, which is an important distinction. Family partnerships generally involve partners who are related; they are constructed to help with estate planning for one or more family members; they involve pooling of family assets and using the partnership to transfer ownership between family members, generally between generations, over some period of time.

The United States does not have specific federal law governing partnership formation and operations. Rather, each state has the ability to adopt its own laws. Two uniform acts, the Uniform Partnership Act and the Uniform Limited Partnership Act,1 have been adopted in many states to provide some commonality to the legal aspects of partnership activities. The federal government has, however, adopted detailed and extensive tax laws related to all aspects of a partnership. These laws, along with the regulations promulgated by the Internal Revenue Service, provide a very detailed road map for all aspects of a partnership's "life."

The Tax Life-Cycle of an Investment Partnership

A partnership is not a tax-paying entity. The income or loss of a partnership flows through to its partners, who report the items on their tax returns. A partnership is a tax-reporting entity, though, and it files an annual tax return. Most partnerships follow a calendar year and their returns are due by April 15 of the following year, just like individuals.

An investment partnership has three tax-related aspects of its "life": how assets get into the partnership, how partners are taxed during their tenure within the partnership, and how assets get out of the partnership.

Partnership formation. A partner can acquire an initial (or subsequent) interest in a partnership by either purchasing the interest from an existing partner or by contributing assets to the partnership in exchange for an interest. Each of these actions brings into consideration the new partner's tax basis in the interest acquired. This is important because the partnership interest itself is considered an asset, and the basis of that asset can impact the recognition of losses from the partnership.

If a new partner purchases the interest from an existing partner, the basis is simply the purchase price (assuming a cash transaction). If the new partner exchanged assets for an interest, the basis in the partnership is the same as the basis in the contributed assets.2 For example, a new partner might contribute appreciated stock to a partnership in exchange for an interest in the partnership. The good news is that this transaction does not result in a taxable event; the new partner is not deemed to have sold the stock. Rather, the basis in the stock becomes the basis in the partnership. However, should the partnership sell the stock within seven years of its contribution, any gain remaining from the "built-in" gain at the time of contribution must be allocated back to the contributing partner.

Let's say Susan contributed 100 shares of Superco stock to a partnership in exchange for a 5-percent interest in the partnership. Additionally, if the partnership sells the stock within seven years of its contribution, any gain remaining from the "built-in" gain at the time of contribution must be allocated back to the contributing partner.

Let's say Susan contributed 100 shares of Superco stock to a partnership in exchange for a 5-percent interest in the partnership. Additionally, if the partnership sells the stock within seven years of its contribution, any gain remaining from the "built-in" gain at the time of contribution must be allocated back to the contributing partner.
Though a partnership itself is not a seller, when a partner wants to sell Superco and use the proceeds to acquire a different investment, Susan wants to sell Superco and use the proceeds to acquire a different investment. She has contributed $15,000 worth of property to the partnership, and the stock has an embedded gain of $8,000 (i.e., $150 – $70 times the 100 shares).

Now, let's assume the partnership wants to sell Superco and use the proceeds to acquire a different investment. When sold, Superco is trading at $110 per share. Susan is only a 5-percent owner of the partnership, but she will be allocated all of the realized gain of $4,000 ($110 – $70 times 100 shares), because the property was sold in less than seven years. If the property were sold after seven years, she would recognize only 5 percent of the gain or $200 in our example here, with her other partners recognizing the remaining $3,800.

The pass-through partnership. Although a partnership itself is not subject to tax, it does need to calculate taxable income. Taxable income, or loss, is allocated to each partner annually. The partnership is required to provide to each partner a Schedule K-1, which is part of the partnership’s annual tax return. The Schedule K-1 provides each partner with his share of all of the items of income and loss from the partnership.

A partnership first calculates its taxable income or loss, using basically the same rules an individual would use to report a sole proprietorship. For example, if the partnership were in the business of renting houses, it would need to calculate the rental income and rental expenses from all the properties to arrive at a net income or loss.

Because a partnership can have different types of partners (e.g., individuals, corporations, charities, foreign entities), all the different components of income must be reported separately. This allows each partner to treat its share of the income or loss exactly as if it had been the sole creator of the results. The rental example, total rental income or loss would be one of those line entries on the Schedule K-1, as would tax credits, gains or losses on the sale of partnership assets, or items specific to the alternative minimum tax. Indeed, one would expect to see the following included on a Schedule K-1:

- Interest income, either taxable, tax-exempt, or both
- Dividends, including both qualified and non-qualified
- Capital gains and losses, both short-term and long-term
- Foreign taxes paid
- Deductible investment expenses
- Investment interest expense

Most partners hope for a gain from their investment partnerships, but losses are a possibility. Partners can utilize partnership losses to the extent that they still have tax basis in the partnership interest. A partner’s basis starts with their contribution, and increases with gains from the partnership, decreases with losses, and is further reduced for distributions from the partnership. If a partnership distributed cash equal to the income it realized during the year, a partner’s basis would be unchanged. It would have increased for the partner’s share of the income and then been reduced by the cash distribution to the partner. Because tax basis cannot be negative, losses in excess of basis are not currently usable. They are not lost, though; partners can utilize losses in the future once they have basis again, which could come from additional contributions or future income within the partnership.

Regarding liabilities: If a partner personally undertakes a liability of the partnership, the liability is treated as a cash contribution: It increases the partner’s basis in the partnership interest. Conversely, were the partnership to assume a partner’s liability, it is the same as a distribution to the partner and reduces the basis.

Distributions of partnership items. A partner recognizes income from the partnership whether the income is actually distributed or not. That could be bad news, since a partner could have taxable income and no cash to pay the income tax. However, the partnership can distribute assets without having to recognize tax as long as the distribution does not exceed the partner’s basis. Once again, a partner’s tax basis determines the tax impact. If the distribution is not money, then any gain (i.e., any excess of the fair market value of the asset distributed over the partner’s basis) is deferred until the partner sells the asset. If the distribution is money—and marketable securities such as stocks and bonds are considered money—the gain is recognized immediately to the extent it exceeds basis. For example, if John had basis of $250 in his interest in a partnership and received $400 worth of a mutual fund in distribution, he would have to recognize $150 of taxable gain, because the mutual fund is a security (so it looks like cash for tax purposes) and the value of the asset exceeded his basis in his partnership interest.

This ability to receive money from a partnership without having to recognize gain can be very useful to an investor. Unlike mutual funds or many other commingled vehicles, it gives the investor the ability to rebalance investments between partnerships without necessarily having to recognize a taxable event.

“This ability to receive money from a partnership without having to recognize gain can be very useful to an investor.”
Let's return to Susan. Let's assume she has investments in two investment partnerships, an equity partnership and a fixed income partnership. Susan has the potential to rebalance between the two with no tax impact. Assuming she has sufficient basis in her partnership interest, she could receive cash from the equity partnership and contribute it to the fixed income partnership. Remember, there is also no tax event on the contribution of assets into a partnership. Had she instead invested in two mutual funds, the rebalancing would have required selling the equity fund, a taxable event, in order to buy more of the fixed income fund. Now, in the interest of full disclosure, this works as long as the equity partnership in our example already had sufficient cash to meet Susan's liquidation request. If it did not, it would have to recognize a taxable event inside the partnership to sell some stock to generate the cash needed for the distribution to Susan. However, again assuming that the securities sold were not ones that Susan had contributed, any gain or loss would be shared by all the partners, not just Susan, so she has been able to move some of the tax burden to her partners.

Often, partners of investment partnerships like to receive property rather than cash in partial or even full liquidation of a partnership interest. Generally, partners assume the same tax basis in the distributed property as the property had inside the partnership. As long as the distribution occurs more than seven years after contribution and doesn't exceed the basis, we don't have to worry about allocating pre-contribution gain to various partners and this distribution is not a taxable event. This is the reason why exchange partnerships\(^7\) have seven-year investment horizons.

### Trade or Business

One final issue related to partnerships that should not be ignored is the difference between trade or business activities and anything else. When a partnership engages in a trade or business, two material things happen. First, the way net income is calculated changes. Individuals receive fewer deductions for tax purposes than businesses, so a partnership that is a trade or business can utilize the business definitions, which potentially increases the number of deductions. But the offset is that the partners now must be concerned with the passive activity rules. These rules were introduced in 1986 and impact the timing of certain deductions and losses from a partnership. Needless to say, the decision to move from an investment partnership, which is not a trade or business, to a partnership that does engage in a business, is a complex one that should be carefully considered.

### Now the Fine Print

No single article can make a person an expert on partnerships let alone partner-ship taxation. Certainly, advisors should consult tax professionals whenever they are working in the area of taxation. While the rules and regulations that Congress and the Internal Revenue Service have issued—and continue to update and change—can be complex, the pooling of assets and sharing of rewards follows a relatively straightforward process. Partnerships can be an effective way for investors to pool assets and enjoy resulting benefits.

R. Samuel Fraundorf, CFA\^\^, CPA, is senior vice president and chief operating officer with Wilmington Trust Investment Management in Atlanta, GA. He earned a BS in accounting and finance from the University of Idaho and an MS in finance from Georgia State University. Contact him at sfraundorf@wilmingtontrust.com.

### Endnotes

1. Proposed by the National Conference of Commissioners on Uniform State Laws (www.nccusl.org). The most recent Uniform Partnership Act was completed in 1997; the most recent Uniform Limited Partnership Act was completed in 2001.
2. More-complicated issues such as property subject to debt or other more complex ownership structures are beyond the commentary here.
3. Title 26 USC 701.
4. Title 26 USC 702.
5. The definition of what is a liability, for example a call option a partner wrote and then contributes to a partnership, is complex and beyond the scope of this article.
6. Again, let's assume that there were no liabilities attached to the asset or other more complex issues associated with the distribution.
7. An exchange partnership is one where a number of partners each contribute one or more securities, such as concentrated stock positions. Assuming 30 partners contributed 30 different stocks, each would hold an interest in a diversified portfolio where each had held a single stock before. After seven years, the partnership distributes each partner’s share of the stock portfolio in the retirement of the partnership, leaving each partner with a portfolio of generally low-basis stock but a diversified portfolio.