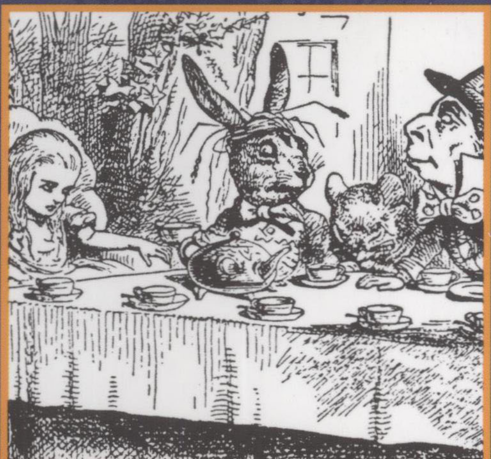
CONCEPTS AND INSIGHTS SERIES

Partnership Income Taxation

Fifth Edition

William H. Lyons and James R. Repetti



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PARTNERSHIP INCOME TAXATION

FIFTH EDITION

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To Karen, Ginger, Kevin, Andy, Rachel, Jeanette
and Bill
W.H.L.

To Susan, Jane, Tom, Caroline, Cleo and Memore
J.R.R.

PREFACE

This book attempts the simplest possible introduction to an intricate body of law. Any "simplified" description of the rules of partnership taxation would be so misleading as to be useless. We have therefore tried to make the subject accessible not by paraphrasing the rules, but by including numerous illustrations that are as straightforward as possible. The text focuses on simple partnerships holding few assets and engaging in routine transactions. It places the rules in context by pointing out the purposes of the statute and regulations and presenting background information about practical matters such as how partnerships maintain capital accounts and how nonrecourse financing works. Using many examples, it then shows the operation of the rules in everyday cases encountered by practitioners.

This is not a reference book: many interesting and difficult issues have been ignored. Some matters, such as the application of § 736 to noncash distributions and tiered partnerships, are not discussed at all, and some problems, like mandatory basis adjustments under § 732(d), receive only passing mention. Most of the points that are dealt with are, however, discussed at considerable length. Our goal has been to give students background material and illustrations so that they can begin to understand and work with a statute that was drafted for (and by) experienced practitioners.

Most chapters end with a section comparing the tax treatment of partners with that of the shareholders of S corporations. Many students encountering partnership taxation for the first time have already studied subchapter S. We expect that an examination of some of the basic differences between subchapters S and K should help those students understand both subjects.

We thank our previous coauthor, Alan Gunn, for all of his contributions to this book. We greatly benefitted from Alan's invaluable insights about partnership taxation and his good humor. He is a masterful teacher to whom we owe much. We also thank James E. Tierney and Larry D. Ward for helpful comments on previous editions.

Lastly, William Lyons gratefully acknowledges the generous support for a portion of this project provided by the McCollum Fund at the University of Nebraska College of Law and James

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The cover picture is John Tenniel's drawing of the mad tea party. It seems a perfect match for a subject that has grown so intricate as to have become, in practice, almost a legal fiction.

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January 2011

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Chapter One

CHOICE OF ENTITY: TAXATION OF PARTNERSHIPS, C CORPORATIONS AND S CORPORATIONS

A. INTRODUCTION

The central principle underlying the federal income taxation[1] of partners is that the existence of the partnership should matter as little as possible. As an American Law Institute study put it, "the ideal mode for taxing partnership earnings is to tax each partner as though he were directly conducting his proportionate share of the partnership business."[2] This mode of taxation is usually referred to as the "aggregate" approach because it treats the partnership as an aggregate of individuals, each conducting her share of the partnership's business. The ALI emphasized, however, that this principle controls only in the absence of countervailing factors.[3] A "countervailing factor" that often makes it undesirable to try to tax partners as if they were conducting their shares of the business as sole proprietors is administrative convenience. Administrative convenience normally suggests that the partnership be treated as an entity separate from the partners, i.e. that the "entity" approach be used.[4]

To illustrate the considerations raised above, think about a laundry business conducted by Alice and Bill as equal partners. Each of them contributed equal amounts of cash, each does identical work, and each takes the same amount of money out of the business. In this very simple case, it is easy to apply the aggregate approach and tax Alice and Bill as if each were conducting half of the business: Each of them can include in income half of the income of the laundry.

Treating the partnership as an "aggregate," as in the example above, is not always practical; sometimes an "entity" approach must be used. Suppose that the laundry building burns down, and that Alice wants to reinvest the insurance proceeds in a new building, electing nonrecognition of gain under § 1033. Bill (who has a large, deductible

1. This discussion focuses on federal income taxation of partnerships and partners. State taxation of partnerships and partners may differ from the federal income tax rules.

2. American Law Institute, Federal Income Tax Project, Subchapter K, 5 (1984).

3. Id. (emphasis omitted).

4. Indeed, concerns about administrative convenience prompted the drafters of the Revised Uniform Partnership Act (1997) to recommend that states use the entity approach in formulating laws that govern the conduct of partnerships so that partnerships can own property as an entity, contract as an entity and be sued as an entity.

loss from another activity) would prefer that the gain be recognized. Can both partners get the tax treatment they want? No: Section 703(b) adopts the entity approach and allows nonrecognition only if the partnership itself makes the election and replaces the building. Section 703(b), with three exceptions, provides that elections affecting the computation of partnership income must be made by the partnership, and § 1033(a)(2)(A) allows nonrecognition only if "the taxpayer" which realized the gain (in this case, the partnership) purchases qualifying replacement property.

As a rule, the amount and character of a partnership's income are calculated using an "entity" approach. The income, however, is taxed to the partners, not to the entity, using the "aggregate" approach. For example, if a partnership realizes gain of $10,000 from the sale of an asset, the entity approach causes the character of that gain to be determined at the partnership level. The gain will be capital gain if the partnership does not hold the property for sale to customers in the ordinary course of business and the other exceptions for capital asset treatment in § 1221 are inapplicable. The aggregate approach will then cause that gain to be taxable to the partners regardless of whether the gain is actually distributed to them.

B. THE FLOW–THROUGH FEATURE OF PARTNERSHIPS AND S CORPORATIONS

Application of the aggregate method to partnership income is one of the most attractive features of partnerships because it results in a single tax being applied to partnership income. When a partnership recognizes taxable income, such income is taxed directly to the partners. The partnership, itself, does not pay a tax on its income.[5] In addition, the subsequent distribution of that income to the partners does not usually trigger an additional tax liability because the aggregate method treats each partner as though she had directly conducted her share of the rental business and had already received her share of the income.

This single-tax approach stands in stark contrast to the double taxation of income of a corporation subject to the tax regime contained in Subchapter C of the Internal Revenue Code.[6] (Corporations subject to the double-tax regime of Subchapter C are often referred to as "C corporations.") Income realized by a C corporation is taxable to the corporation because the corporation is treated for all purposes as an entity separate from its stockholders. When the corporation distributes

5. Although a partnership will not pay federal income tax on its income, a partnership that has employees will be subject to various federal and state employment taxes.

6. Subchapter C consists of §§ 301 through 385.

that income to its stockholders, the stockholders also recognize taxable income.

Example 1–1: Andrew and Rachel are considering whether they should organize a real estate investment business as either a limited liability company (LLC), which is taxable as a partnership, or as a corporation, which is subject to the double-tax regime of Subchapter C. They anticipate that their real estate investments in land will generate rental income of approximately $500,000 per year. Andrew and Rachel have significant income from other sources and are subject to tax at the maximum marginal rates. They have asked their attorney which entity they should use.

Their attorney has advised them of the following tax consequences. If they place their land into an LLC, the $500,000 rental income will be recognized by Andrew and Rachel and they will pay a federal tax of $175,000 (35% of $500,000). No further tax liability will be incurred when the LLC distributes the rental income to Andrew and Rachel since the aggregate principle treats them as having directly conducted the rental business. In contrast, if they place their land into a C corporation, the income will be taxable to the corporation and will be taxed again when distributed to them. This will result in a total tax of $223,750, since a tax of $175,000 is incurred at the corporate level (35% of $500,000) and an additional tax of $48,750 is incurred when the income remaining after payment of the corporate tax is distributed to Andrew and Rachel (15%[7] of $325,000).

Clearly, application of the aggregate method causes an entity taxable as a partnership to be an attractive alternative for conducting a profitable business. In addition, the aggregate method often causes a partnership to be the preferred choice where the business will hold assets that are likely to appreciate in value. The aggregate method means that when a partnership distributes appreciated assets to its partners, neither the partnership nor the partners recognize taxable income. The logic is that since the aggregate method treats each partner as though he holds his share of partnership assets, nothing changes as the result of an actual distribution of those assets. In contrast, when a C corporation distributes appreciated assets to its stockholders, both the distributing corporation and its stockholders recognize taxable income since the corporation is treated as an entity separate from its stockholders. The distribution of an appreciated asset is a realization event for the corporation, triggering

7. Section 1(h)(11) provides that "qualified dividend income" received by an individual will be taxed at a rate of not more than 15 percent.

the corporation's recognition of income. Similarly, receipt of the property also results in income recognition by the stockholders.

Example 1–2: The land that Andrew and Rachel's entity purchased in Example 1–1 for $500,000 has appreciated in value to $1,500,000. If Andrew and Rachel formed the real estate entity as an LLC, the LLC may distribute the land to Andrew and Rachel and neither Andrew and Rachel nor the LLC will recognize taxable income. In contrast, if Andrew and Rachel formed the entity as a C corporation, the corporation will recognize the $1,000,000 difference between the land's tax basis and its fair market value as gain, and the stockholders will also recognize income upon their receipt of the land.

This favorable treatment of the distribution of appreciated assets from a partnership usually leads tax advisors to recommend that assets likely to appreciate in value not be placed into a C corporation. For example, a person considering purchasing a farm or marina should consider placing the farm's or marina's real property into a limited liability company that would be taxed as partnership, not a corporation.

If all the stockholders of a corporation elect to have the corporation subject to the provisions of Subchapter S of the Internal Revenue Code,[8] instead of Subchapter C, a different approach applies. A corporation subject to taxation under Subchapter S, (an "S corporation") has some, but not all of the advantages of an entity taxable as a partnership. Like a partnership, income of an S corporation is taxable to its owners, i.e. to its stockholders, not to the corporation. However, unlike a partnership, taxable income is recognized when an S corporation distributes property that has appreciated in value. Thus, the S corporation provides less flexibility than a partnership.

Example 1–3: The facts are the same as in Examples 1–1 and Example 1–2 except that Andrew and Rachel are conducting their real estate investment business in the form of an S corporation. The $500,000 rental income collected by their S corporation is not taxable to the S corporation. Instead, Andrew and Rachel are each taxed on their share of the corporation's income.

If the S corporation distributes the land that has appreciated in value to $1,500,000, it recognizes $1,000,000 of gain (the difference between the $1,500,000 value and $500,000 tax basis). This gain flows out to and is recognized by the S corporation stockholders on their individual tax returns. The stockholders normally do not also recognize additional taxable income as a result of receiving the distribution. Thus, only one level of tax

8. Subchapter S consists of §§ 1361 through 1379.

is usually assessed as a result of an S corporation's distribution of appreciated property. This means that the S corporation is preferable to C corporation, which is subject to a double tax, but not to a partnership, which would generate no tax.

Similar to income, expenses of a partnership and an S corporation also flow out to partners and stockholders. The ability of partners and S corporation stockholders to obtain immediate tax benefits from such expenses, however, may be significantly affected by limitations discussed in Section C of Chapter 3.

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