PacificCPE

Character and Presentation of Partnership Income

Course #33053B

Taxes

2 Credit Hours

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CHARACTER AND PRESENTATION OF PARTNERSHIP INCOME

This course provides a clear overview of the requirements for claiming the Section 199A deduction. It explains who qualifies, how the deduction is calculated, income thresholds, and limitations related to specified service trades or businesses (SSTBs). The course offers essential guidance for maximizing this valuable deduction for pass-through business owners.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Character and Presentation of Partnership Income

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall the requirements of the Code Sec. 199A deduction.

NOTICE

Program publication date **10/7/25**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: CHARACTER AND PRESENTATION OF PARTNERSHIP INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Recall the requirements of the Code Sec. 199A deduction.

¶501 INTRODUCTION

A partnership is not a separate tax-paying entity. Rather, the partnership's income (or loss) is passed through to its partners, who then compute their tax liabilities based on the rates in Code Sec. 1.[1]

Generally, as discussed in Course 33052B, a partnership computes its taxable income in the same manner as do individuals.[2] Once computed, the partnership's items of income, loss, deduction, or credit are passed through to partners for inclusion in their taxable income for their tax year in which the taxable year of the partnership ends.[3] Items that may have potentially varying tax consequences to particular partners must be separately stated;[4] all other items are aggregated and passed through as a net lump sum.[5] These items are allocated among the partners in accordance with the partnership agreement.[6] The partnership's pass-through items retain the character they possessed at the partnership level; for example, tax-exempt interest earned by the partnership is treated as tax-exempt interest in the hands of the partners.[7]

S Corporation Observation

In contrast to the flexibility extended to partners, who can make disproportionate or special allocations of tax items if such allocations have "substantial economic effect," special allocations of tax items among the S corporation shareholders are not allowed.[8]

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1. Code Sec. 703(a).
2. Id.
3. Code Sec. 706(a).
4. Code Sec. 703(a)(2).
5. Code Sec. 702(a)(1) and (8).
6. Code Sec. 704(a). In contrast, the pro rata share of a shareholder of an S corporation is determined by allocating an equal portion of each item to each day of the corporation's taxable year, and then dividing that amount by the shares outstanding on the day. Code Sec. 1377(a)(1). As in the case of partnerships, the IRS has the authority to make adjustments to the amounts passed through where such is necessary to reflect the value of services or capital provided by a family member of one or more shareholders. Code Secs. 704(e) and 1366(e).
7. Code Sec. 702(b).
8. S corporations can in effect "specially allocate" amounts of income among their owner-employees only through salary adjustments. Amounts of income allocated among shareholders can also be altered through changes in stock ownership. The shareholders must, however, transfer their stock during the year for the allocation to be effective because the S corporation's income is allocated among the shareholders based upon the number of days they have owned the shares. In contrast, partnership income is allocated according to the partnership agreement, including amendments made by the due date of the (continued)

The character of a tax item realized by a partnership "shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership."[9] Although this language has been the subject of academic discussion, the generally accepted view is that the character of the item is determined by reference to partnership-level factors.[10]

Example 5-1

EXAMPLE

A real estate dealer who trades in apartment buildings is a limited partner in a partnership that owns an apartment building it has managed for 20 years. The partnership sells the building under circumstances such that its gain is considered Code Sec. 1231 gain. Each partner's share, including the real estate dealer's, is taxed as Code Sec. 1231 gain.

Generally, a partner increases his or her basis by the amount of taxable and tax-exempt income passed through, and decreases his or her basis (but not below zero) by items of loss and deduction and any expenses of the partnership that were not deductible in computing its taxable income and which were not properly chargeable to capital account (*e.g.,* life insurance premiums paid to insure the lives of the partners).[11]

¶502 PRESENTATION OF A PARTNERSHIP'S TAXABLE INCOME

Although a partnership accounts for roughly the same items of income and deduction as an individual, the format in which it reports this information is quite different. An individual first subtracts from his or her gross income the sum of his or her "above the line" deductions. This subtotal is the individual's "adjusted gross income."[12] An individual next reduces adjusted gross income by the sum of any "itemized deductions."[13] The resulting *single* number is taxable income.[14] A partnership reports the results of the taxable year's operations differently. It separately lists the net amount of any item of income, loss, or deduction that could affect the various partners differently.[15] For example, tax-exempt interest income and other tax exempt income are each separately stated. The net amount of each type of nondeductible

tax return. It is possible, therefore, for the partners to wait until the tax year is complete before deciding how to allocate the partnership's income among themselves. In the case of an S corporation, unlike a partnership, it is impossible to allocate a particular item of income or deduction. Depreciation, for example, is required to be shared by all the shareholders based upon their stock ownership

9. Code Sec. 702(b).

10. United States v. J.A. Basye, 73-1 USTC ¶ 9250, 410 US 441, 93 SCt 1080. The opposite interpretation is that a partner treat partnership items as if he or she generated them directly. For example, a partner who was a dealer in land would treat the partnership's land sale as if it were his or her sale, ordinary income being the likely result. The entity-level partnership characterization rule is de scribed in Rev. Rul. 67-188, 1967-1 CB 216. See also E.G. Barham v. United States, 69-1 USTC ¶9356, 301 FSupp 43 (D. Ga.).

11. Code Sec. 705.

12. Code Sec. 62. An individual income tax return (Form 1040) will take these deductions into account on page one or its supporting schedules.

13. Itemized deductions are all deductions not enumerated in Code Sec. 62.

14. Code Sec. 63.

15. The net amount of each item is shown on a separate line of Schedule K (Form 1065, U.S. Return of Partnership Income).

expenditure is separately listed.[16] Any item of a partnership's income or deduction which is specially allocated to a particular partner is separately stated even though absent the special allocation it need not have been separately stated. The remainder of the partnership's items of income, loss, and deduction are simply aggregated as one net number.[17] Unlike an individual, a partnership's taxable income is not reduced to one number.[18] This section discusses which items of partnership income and deduction must be separately stated.

¶503 SEPARATELY STATED ITEMS

The law provides only that a partnership must separate its items of income, loss, and deduction that could, by their nature, affect the various partners differently.[19] But it is also necessary to inform the partners of their shares of nontaxable income and expenditures that are not deductible by the partnership. Normally, the partnership tax return preparer will probably not separately report to the partners each item that might conceivably constitute a separately stated item of income, loss, and deduction. It is therefore not unlikely that partners may need to request additional information in order to prepare their returns.

A partnership is denied certain deductions.[20] In most cases the result is clear. The partnership acts in a manner similar to that of a nominee. It reports the amount and nature of the nondeductible expenditure to the partners, and its intermediary status is ignored. The partners are simply treated as if they had paid the amounts directly.[21] Because the partners' bases are reduced by nondeductible expenditures, these payments are often dealt with as if the partnership first distributed these amounts and then the partners made the payments themselves.[22]

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16. These items are reported separately on Schedules K and K-1. Each partner will decrease his or her partnership interest adjusted basis for his or her share of nondeductible expenditures and increase his or her partnership interest adjusted basis for tax-exempt income.

17. This net number is calculated on page one of the Form 1065 and is the first entry on Schedule K.

18. When it is necessary for a partner to know his or her gross income from all sources such gross income includes the partner's pro rata share of the partnership's gross income. Code Sec. 702(c). This amount is not normally part of the information provided with the partner's K-1.

19. Code Sec. 702(a)(1)-(8).

20. Code Sec. 703(a)(2).

21. The partners are required to reduce partnership interest adjusted basis by their share of the expenditure. Code Sec. 705(a)(2)(B). This is because the partnership no longer has the money and its ownership interests are therefore less valuable. If a partnership interest adjusted basis reduction were not required the partner would have a loss or reduced gain on the sale of his or her ownership interests and this would result in a second tax benefit for the same expenditure. The result is very similar to treating the partnership as having distributed the nondeductible amount to the partner who paid it to the ultimate payee. The partnership interest's basis should, however, be reduced only once, not for both the nondeductible expenditure and the deemed distribution.

22. The partners will be required to reduce their bases in their partnership interests by their allocable shares of nondeductible expenditures. Code Sec. 705(a)(2)(B). Absent this basis adjustment the partners would receive a tax benefit for expenditures that should be denied at both the partner and partnership level. For example, neither the partnership nor partner should be entitled to deduct expenses incurred to produce tax-exempt income. If a partnership's funds have been spent providing life insurance the interests in the partnership have been reduced in value by the amount of the expenditures. If the partner's basis in their interests is not reduced by the expenditure, subsequent sale of the partnership interest will generate additional loss or a reduced amount of gain in the amount of the expenditure. For amounts that are deductible by the partner but not by the partnership, absent a basis reduction to the partnership interests, a double tax benefit will be generated by items passed through to the partner and deducted by him or her. Investment expenses other than interest are an example of a possible double deduction if no basis adjustment is made. Code Sec. 212 allows an individual to deduct such expenditures, but a partnership is disallowed Code Sec. 212 expenses. A deduction that is allowed to an individual by Code Sec. 212 is specifically disallowed to a partnership. The tax return for a partnership requires that these expenses be separately stated. (Schedule K, Form 1065.) The individual partner deducts these amounts along with his or her other itemized deductions. If he or she is not required to reduce his or her ownership interest's basis by the expenditure, the ownership interest's sale at its reduced value caused by the expenditure will generate a loss or a reduced amount of gain reflecting such expenditures as an additional tax benefit.