PacificCPE

COURSE
33053C

Partnerships: Calculation, Character and Presentation of income

Understanding how income retains its character as it flows through a partnership is essential for accurate tax reporting and client planning. This course examines how different types of income, gain, loss, and deduction are characterized at the partnership level and what that means for individual partners. LLC-specific rules and comparisons to S corporation treatment are highlighted throughout, giving you a well-rounded perspective on how entity choice can affect the nature of income your clients ultimately report.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

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

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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[1] through to its partners, who then compute their tax liabilities based on the rates in Code Sec. 1.

Generally, as discussed in Chapter 2 of course 33052D, a partnership computes its taxable income in the same manner[2] as do individuals. 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[3] year of the partnership ends. Items that may have potentially varying tax consequences to particular[4] partners must be separately stated; all other items are aggregated and passed through as a net lump[5][6] sum. These items are allocated among the partners in accordance with the partnership agreement. 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[7] the partners.

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,"[8] special allocations of tax items among the S corporation shareholders are not allowed.

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

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[1413]." The resulting single number is taxable income. 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 [15] deduction that could affect the various partners differently. 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[16] expenditure is separately listed. 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[17] are simply aggregated as one net number. Unlike an individual, a partnership's taxable income is not[18] reduced to one number. 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,[19] by their nature, affect the various partners differently. 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.[20]

A partnership is denied certain deductions. 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[21] the amounts directly. 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[22] made the payments themselves.

There is a slim technical distinction between a partnership's nondeductible separately stated item of expenditure and a partnership's separately stated deductible expenditure. The possible difference exists in the application of the basis limitation on the deductibility of losses. A partner's "distributive share of partnership loss (including capital loss) shall be allowed only to the extent of the adjusted basis of such partner's interest in the partnership[23]." A literal interpretation of the basis limitation rules would conclude that the partner is not subject to those rules for her share of the partnership's nondeductible expenditures[24].

.01 Rental Real Estate Activities

Income and expenses attributable to partnership rental real estate activities flow through to the partners as real estate rental activity. Passive losses incurred in rental real estate activities are subject to a special $25,000 deduction allowance in excess of passive income at the general partner level depending upon the level of the partner's adjusted gross income and whether he or she "actively participates" in the rental activity[25]. Also, taxpayers who qualify as being in a "real property business" who materially participate in any real estate rental activity may treat the entire income or loss from that activity as nonpassive[26].

The partnership has the obligation to group its various activities under the passive activity loss grouping rules. The partner then may group activities conducted directly

and through other Code Sec. 469 entities with the activities of the partnership. A shareholder or partner may not treat activities grouped together by a partnership as separate activities. He or she may only combine his or her share of the partnership defined activity with other activities to form a group larger than the partnership[27]. S corporations must report rental real estate activities on Form 1120-S in the same way partnerships do on Form 1065.

.02 Rental Activities Other Than Real Estate

Income and expenses attributable to non-real estate rental activities generally flow through to the partners as passive without the special $25,000 allowance or the active income treatment available to real estate operators described in the previous paragraph. The partnership also has the obligation to define the boundaries of these various activities[28].

.03 Compensation Paid to Service Partners

Partnership payments to a partner for independent contractor type services which are subject to Code Sec. 707(a) are not subject to withholding. The related deduction is not separately stated unless it is specially allocated. The payment to the partner is reported on a Form 1099 and not the partner's K-1 or Form W-2. A partner who receives payments from the partnership for required partner/employee type services rendered which are determined without regard to partnership profits (these are guaranteed payments under Code Sec. 707(c)) is not regarded as an employee of the partnership for purposes of withholding. The partnership's deduction for guaranteed payments is not separately stated unless it is specially allocated. The partnership's total guaranteed payments are deducted on Form 1065, line 10. Unlike Code Sec. 707(a) payments, Code Sec. 707(c) payments made to a partner are not reported on Form 1099, but rather appear as a separately stated amount on Schedule K-1, box 4a (if for services), and 4b (if for capital). Total guaranteed payments are reported on Schedule K, line 4a (if for services), and line 4b (if for capital). For more detail related to the deductibility timing, character, and other treatment of payments to partners, see 404. Compensation paid to any employee other than a partner is subject to withholding for income tax purposes and is also subject to withholding for FICA and FUTA purposes[30][29]. Liability is imposed under such provisions with respect to "wages." The term "wages" is defined by Code Secs. 3121(a) and 3306(b) as "all remuneration for employment." The definition of wages for purposes of withholding is similar. It should be noted that S corporations have no equivalent to the guaranteed payment, and thus no equivalent disclosure on line 4 or in box 4 of Schedules K and K-1.

LLC Observation

Although for nontax purposes LLCs resemble corporations, for federal income tax purposes they are generally treated as partnerships (since their members generally elect to be treated that way, and that is usually the default treatment). The rules described immediately above apply in the same manner to LLCs and LLPs. Unlike publicly traded corporations, LLCs, LLPs, and other partnerships are not subject to the $1,000,000 compensation deduction limitation of Code Sec. 162(m). This is so even if a publicly traded corporation is a partner in a partnership, and the partnership and the corporation have common employees[31].

.04 Interest and Royalty Income

The partnership separately states its total interest and royalty income on Form 1065, Schedule K, on lines 5 and 7, respectively. Each partner's share of the partnership interest and royalty income is shown on Schedule K-1, in boxes 5 and 7. An S corporation discloses total interest and royalty income on Form 1120-S, Schedule K, on lines 4 and 6, respectively. Each shareholder's share of the S corporation interest and royalty income is shown on Schedule K-1 (Form 1120-S), boxes 4 and 6.

.05 Dividends

The deduction allowed under Code Sec. 243 to corporations for a percentage of the dividends received from other corporations is not allowed to a partnership because its taxable income is computed as if it were an individual. Corporate partners will separately determine their eligibility for this deduction. The corporate partner will not be required to reduce the basis of their partnership interest for this deduction. The partnership separately states its ordinary dividend income on Form 1065, Schedule K, line 6a, "Ordinary dividends[32]." Each partner's share of ordinary dividends is shown on Schedule K-1, box 6a, "Ordinary dividends." The amount for "Ordinary dividends" will generally include the amount of "Qualified dividends" disclosed on line 6b and in box 6b of the Schedules K and K-1, respectively. Dividend equivalents under Code Sec. 871(m) are disclosed on line 6c and in box 6c of Schedule K and K-1, respectively. These are not applicable to S corporations.

For purposes of determining the tax on long-term capital gains, "qualified dividend income" is added to net capital gain and adjusted net capital gain[33]. However, in computing the tax on dividends, the qualified dividend income cannot be offset by any capital losses[34]. The net effect of these rules is to tax qualified dividend income at a 0, 15, or 20% rate (plus a possible additional 3.8% net investment income tax), depending

on what the taxpayer's taxable income is[35]. The following chart summarizes the capital gains tax rates in effect for 2025 based on taxable income:

Taxable Income Level

Taxable Income Level				
Capital Gain Tax Rate	**Single**	**Married Filing Separately**	**Head of Household**	**Married Filing Jointly**
0%	Up to $48,350	Up to $48,350	Up to $64,750	Up to $96,700
15%	$48,351 - $533,400	$48,351 - $300,000	$64,751 - $556,700	$96,701 - $600,050
20%	Over $533,400	Over $300,000	Over $556,700	Over $600,050

"Qualified dividend income" consists of dividends received from domestic and qualified foreign corporations, but only if the taxpayer held the stock for at least 61 days of the 121-day period beginning 60 days before the ex-dividend date[36]. The partnership separately states its qualified dividend income on Form 1065, Schedule K, line 6b, "Qualified dividends." Each partner's share of qualified dividend income is shown on Schedule K-1, box 6b, "Qualified dividends." S corporations treat dividends in the same way as partnerships do, but an S corporation discloses its ordinary dividend income on Form 1120-S, Schedule K, line 5a, and its qualified dividend income on line 5b. Each shareholder's share of ordinary dividends and qualified dividends are shown on Schedule K-1 (Form 1120-S), in box 5a and 5b, respectively.

.06 Capital Gains and Losses

Short- and long-term capital gains and losses are each separately netted and stated as two net amounts[37]. The reporting procedure for partnership (and S corporation) capital gains and losses and other portfolio income and expenses is discussed at 503.08. The special tax rates for net long-term capital gains are discussed above at 503.05.

Carried interests. Code Sec. 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests (API) as short-term capital gains. The provision generally requires that a capital asset must be held for

more than three years for capital gain allocated with respect to any API to be treated as long-term capital gain[38].

The term "applicable partnership interest (also more generally referred to in the financial community as "carried interest") means any interest in a partnership which, directly or indirectly, is transferred to the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business[39]. The term "applicable trade or business means any activity (a) conducted on a regular, continuous, and substantial basis which (b) consists, in whole or in part, of raising or returning capital, and (c) either investing in or developing "specified assets[40]. "Specified assets are securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing[41].

Generally, a partnership in which a partner owns an API must attach Section 1061 Worksheet A to the partner's Schedule K-1. In addition, the partner must attach Section 1061 Worksheet B to their Form 1040.

.07 Code Sec. 1231 Gains and Losses

The partnership's net Code Sec. 1231 gain or loss is separately stated on Form 1065, Schedule K, line 10, "Net section 1231 gain (loss)" (Form 1120-S, Schedule K, line 9 for S corporations). The partnership's net Code Sec. 1231 gain or loss from rental activity should be specified. Each partner is allowed to treat his or her net share of the partnership's Code Sec. 1231 gains and losses as if they were a direct result of his or her sales activity. The Code Sec. 1231 character is determined at the partnership level but each partner combines his or her net share of the partnership's Code Sec. 1231 gains and losses with such gains and losses from all other sources[42]. Gain characterized as ordinary income under recapture provisions which is not required to be specially allocated is not separately stated and is therefore netted with the other nonseparately stated items on page one of Form 1065[43]. The partnership's total ordinary nonrental income from depreciation recapture is entered on Form 1065, line 6, "Net gain (loss) from Form 4797, part II, line 17[44]." Recapture income from rental activities is part of the net income or loss from rental activity. Code Sec. 1231 requires a preliminary netting of gains and losses from thefts and casualties of trade and business assets[45]. If this preliminary netting results in a loss, each loss is treated as an ordinary loss and it is not part of the general Code Sec. 1231 netting process. A partnership which has casualty and theft gains and losses should report two net Code Sec. 1231 amounts—the net gain or loss from casualties and thefts and the net of the