Tax and Business Alert 0823

Word count: 343

Abstract: Business partnerships may include situations that give the partners pause. This article explains that in any given year, the partners may have been taxed on more partnership income than was distributed to them. It notes that the cause of this quirk of taxation lies in the way partnerships and partners are taxed.

A possible tax quirk of being a business partner

If you're a partner in a business, you may have encountered a situation that gave you pause. In any given year, you may have been taxed on more partnership income than was distributed to you. The cause of this quirk of taxation lies in the way partnerships and partners are taxed.

Unlike regular corporations, partnerships aren't subject to income tax. Instead, each partner is taxed on the earnings of the partnership — even if the earnings aren't distributed. Similarly, if a partnership has a loss, the loss is passed through to the partners. (However, various rules may prevent partners from currently using their shares of the partnership's loss to offset other income.)

While a partnership isn't subject to income tax, it's treated as a separate entity for purposes of determining its income, gains, losses, deductions and credits. This makes it possible to pass through to partners their share of these items.

A partnership must file an information return, which is IRS Form 1065, "U.S. Return of Partnership Income." On this form, the partnership separately identifies income, deductions, credits and other items. This is so partners can properly treat items that are subject to limits or other rules that could affect their treatment at the partner level. Examples of items that may require special treatment include capital gains and losses, interest expense on investment debts, and charitable contributions. Each partner gets a Schedule K-1 showing his or her share of partnership items for the year just ended.

Basis and distribution rules ensure that partners aren't taxed twice. A partner's initial basis in his or her partnership interest (which varies depending on how the interest was acquired) is increased by his or her share of partnership taxable income. When that income is paid out to partners in cash, they aren't taxed on the cash if they have sufficient basis. Instead, partners reduce their basis by the distribution amount. If a cash distribution exceeds a partner's basis, then the excess is taxed to the partner as a gain.

Contact us with whatever questions you may have.