Acc. 433, Chapter Outline for use with Prentice Hall's Federal Taxation Corporations

TEST 2 Outline

9) **Partnership Formation and Operation**
    a) **Definition**
        i) **Group, syndicate, partnership, or unincorporated entity etc.**
        ii) **Includes limited and general partnerships, LLP's and LLC's**
        iii) **That carries on a trade or business or financial operation**
    b) **Overview:**
        i) **A partnership is not a tax paying entity**
        ii) **It simply reports total income by category and then each partner pays tax on his, her or its share of each item**
        iii) **Partner's basis is equal to**
            (1) Original basis (cost, inheritance etc.), plus
            (2) Share of liabilities
                (a) Recourse, shared by general partners based on loss sharing
                (b) Non recourse, shared by all partners based on profit sharing
        iv) **Basis can never be less than 0.**
            (1) Distribution - see Ch. 10
    c) **Formation - contributions**
        i) **Non recognition - even on later (non formation) contributions**
        ii) **Exceptions:**
            (1) Investment partnerships
            (2) Contributions followed by distributions (within 2 years)
            (3) Contributions with liabilities assumed that are greater than basis
        iii) **Treatment of liabilities**
            (1) Increase each partner's basis by their share of contributed liabilities
            (2) Decrease contributing partner's basis by its share of liabilities assumed by the other partners
                (a) This is treated as a cash distribution
        iv) If it is greater than basis, then there is a gain - see above!Partner's basis (outside - as differentiated from inside) equals:
            (1) Money contributed, plus
            (2) Basis of property contributed,

v) + or - liabilities as described above

d) Partner's holding period - carry over

i) Includes the time the contributed property was held

ii) For inventory, begins the day after contribution

e) Partnership's basis

i) Same as the partner's

ii) Plus any gain recognized

f) Character of the property to the partnership also carries over Section 724

i) Unrealized receivables,

ii) Inventory

iii) Capital loss property

g) Contribution of Services (rather than of property)

i) Must recognize income

ii) Equal to FMV, equal to the value of the capital account

iii) What if they only get a profit's interest, no FMV?

iv) The partnership must determine what the payment relates to and treat the "expense" accordingly

h) Organization, Syndication and Start-Up costs

i) Organization costs are capitalized and amortized over 60 months, if elected

(1) Legal fees

(2) Accounting fees

(3) Business plan

ii) Syndication fees are capitalized and can not be written off until the partnership terminated

(1) Sales costs

(2) Commissions to brokers

iii) Start up, may expense $5,000 and capitalize the rest and amortize straight line over 15 years. Same for pre-opening. If the total exceeds $50,000, reduced dollar for dollar. Thus, if over $55,000, it is amortized over 15 years.

(1) Cost incurred prior to opening (also known as pre-opening costs. See above for start up.

(2) Often incurred in the restaurant business

i) Partnership's tax year - very mathematical. Must use the following order

i) The same tax year as one or ore of the majority partners

(1) Greater than 50%

(2) Capital and profits

ii) If not majority year, then the same year as all of the principal partner(s)

(1) Anyone who owns 5% or more of capital or profits

(2) Don't count less than 5% owners

iii) If no principal year, then the least aggregate deferral

iv) May also elect a tax year if there is a business purpose

(1) 25% of income in the last 2 months of the year

(2) Must prove it with records, so can't elect for a new business

- **v) Section 444, may elect up to a three month deferral, but must make "required payments"**

j) Partner (rather than partnership) elections
- **i) Forgiveness of indebtedness income**
- **ii) Foreign tax credit versus deduction**
- **iii) Mining expenses**

k) Partnership Taxable Income
- **i) First determine income for the partnership without regard to how the partners share!**
- **ii) Partnership income, expense, gains, deductions, credits, etc are separated as if one were preparing an individual's or a corporate tax return.**
  - ***(1) Those business items with no other tax significance are treated as ordinary income and placed on page one of the return (almost as if it were a business income (Schedule C on an individual's return)***
    - (a) It does not matter if the partner is active or passive!
    - (b) Sales
    - (c) Cost of goods sold
    - (d) Salaries
    - (e) Guaranteed payments to partners (salary equivalent paid to a partner
    - (f) Depreciation
    - (g) Recapture of depreciation!
  - ***(2) Other items, whether business or non business must be separated and reported separately, if the item could have separate tax significance to a partner - Reported on Schedule K***
    - (a) Guaranteed payment on Schedule K and page 1
      - *(i) the one on Sch. K is the income to be reported by the partner*
      - *(ii) the one on page 1, is the deduction for the partnership*
    - (b) Capital Gains and losses
      - *(i) Short term*
      - *(ii) Long term*
    - (c) Interest income
    - (d) Dividend income
    - (e) Passive Activity
    - (f) Foreign taxes paid, credits, etc
    - (g) Tax exempt income
      1. §179 (Expense rather than depreciation)
      2. Any other item that could affect the calculation of a taxpayer's liability

l) Distributive Share - Once the partnership's income has been determined, all items of income, loss etc. must be allocated according to each partner's distributive share (has nothing to do with cash distributions)
- **i) Based on the partnership agreement**
- **ii) May be oral or written**
  - ***(1) May be amended until the due date of the return (not in book)***
  - ***(2) If oral, generally equal partners***
  - ***(3) May share different items by different percentages***
- **iii) Varying interest rule - if interests change, must allocate by days**
  - ***(1) Either by total for the year pro-rated, or***
  - ***(2) Can close the books and allocate actual amount***

- **m) Special Allocations**
  - ***i) Can allocate all of one type of income to one partner and all of another type to a different partner***
  - ***ii) Contributed property with gain potential - the gain at time of contribution must***
- **n) Substantial Economic Effect ("SEE")**
  - i) If this applies, then the IRS will not follow the partnership agreement, because it is only for tax purposes, not real (economic)
  - ii) Not SEE if the cash distributions don't follow the capital account
    - *(1) Suppose all losses are given to A, but cash is distributed 50% each to A and B*
    - *(2) Since A and B get the same cash, regardless of their capital account, the loss allocation to A does not have SEE*
    - *(3) OK if partner's must make up their negative capital account (or minimum gain charge-back applies*
    - (4) Not SEE if the allocation does not affect cash distribution in total
      - *(a) A gets the first $10,000 of tax exempt income and B gets the first $10,000 of dividend income*
      - *(b) Not SEE because even though the capital accounts will be respected, the allocations were only for tax purposes*
- **o) Basis of partner's interest (outside)**
  - **i) Beginning is based on cost, gift, inheritance, etc.**
  - **ii) Liabilities**
  - ***iii) Increase a partner's basis by an increase in liabilities***
  - ***iv) Decrease a partner's basis (and treat it as a cash distribution) for***
    - (1) a decrease in the partner's share of partnership liabilities
    - (2) a contribution of debt (% of debt taken over by the other partner's
- ***p) Allocation of partnership debt***
  - i) Recourse loans
    - *(1) Only to the general partners since they will have to pay it - shared based on loss sharing percentage*
    - *(2) Limited partners share in recourse to the extent of their obligation to contribute to capital*
    - (3) Non recourse loans
      - *(a) Shared by all partners - since the bank and creditors are left holding the bag, not the partners*
      - *(b) Sharing is therefore based no profit sharing percentages*

q) At Risk limited to amount that a partner can loose
- **i) capital account, plus**
- **ii) debt for which the partner is liable**

r) Passive Activity
- **i) Determined by each partner, not the partnership as to the ordinary income, unless**
- **ii) The partnership is passive, such as rental income**

s) Sales of property between partners and partnership
- **i) Loss: If more than 50% owner (including attribution) then no loss will be allowed on sales between the two**
- **ii) Gain: If more than 50% owner, then what would be capital gain or §1231 gain will be ordinary if the property is depreciable in the hands of the partnership**

t) Most fringe benefits are not allowed as deductions, because those rules apply to employees, and partners are not employees

u) Guaranteed Payments (like salary to a partner)
- **i) Can also apply to interest on loans to the partnership**
- **ii) Only applies if guaranteed**
  - ***(1) Thus, if A gets the first $100,000 of profits, that is not a guaranteed payment, because if there are not profits then A doesn't get it!***
  - ***(2) If A gets $100,000 guaranteed and the partnership has $20,000 profit before the guarantee, then net income is ($80,000)***
  - ***(3) Guaranteed payments are on the accrual method, even if the partnership is cash basis***
  - ***(4) The partner must therefore report the income, even if it is not received!***

v) Family partnerships
- **i) Must pay reasonable salaries**
- **ii) If not, the IRS can reallocate (deem a salary)**

w) Tax Reporting
- **i) Due date, 3 1/2 months (April 15th for a calendar year p/s)**
- **ii) Penalty for failure to file is stiff, $50 per month per partner, even though no tax is due**

x) Self- employment income
- **i) Generally equals page 1 (or ordinary income), plus guaranteed payments**
- **ii) Applies to all general partners, even if they do not participate**
  - ***(1) That can be very expensive***
  - ***(2) 15.3%***

10) **Special Partnership Issues**
   a) **Distributions can be either Liquidating or Non-Liquidating**
   b) **Non Liquidating**
   c) **For Chart - See Appendix I**
   d) **Holding Period of property distribution is equal to partnership's holding period**
   e) **Unrealized receivables and inventory continue (inventory for 5 years) as ordinary income in the hands of the partner, even if it would be a capital asset**
   f) **Section 751 assets that are distributed in non pro rata shares may cause gain**
   g) **Termination of an interest**
      i) **Gain only if cash exceeds basis**
      ii) **Loss only if basis is greater than cash, plus basis of inventory and receivables and there is no other property**
   h) **Sale of a partnership interest**
      i) **Generally treated as the sale of a capital interest**
      ii) **Exception: Must recognize ordinary income if Section 751 assets (inventory and receivables)**
      iii) **No adjustment made for the buying partners, unless a § 754 election is made or is in effect**
   i) **Retirement or death of a partner**
      i) **Purchase of interest by p/s**
         (1) If arm's length purchase by partnership, IRS will respect it
         (2) Not deductible by the partnership
      ii) **If not a purchase, can be a guaranteed payment or a distributive share, depending on the agreement**
   j) **Tax year of partner who sells or exchanges their entire interest closes on the date of sale or exchange (the partnership's year continues!)**
      i) **Same at the time of death, so income is pro-rated at date of death**
   k) **Termination of the partnership**
      i) **If no more business is conducted**
      ii) **Within a 12 month period (not a tax year), there is a sale or exchange of at least 50% of the partnership interests**
         (1) Must be of both capital and profits
         (2) Same interest sold twice is not counted twice
         (3) Gifts or transfers at death are not sales or exchanges
      iii) **If terminated, the tax year closes**
      iv) **Treat the termination as a liquidating distribution, followed by a contribution of the assets**
   l) **Section 754 - Optional Adjustment to Basis – see handout on Black Board**
      i) **Must be elected**
      ii) **Once elected applies to future years**
      iii) **Requires (allows) inside basis to be adjusted to the outside basis in the case of sales, exchanges, deaths or terminations**
         (1) Adjustment is unique to the affected partner
      iv) **Also applies on distributions in which basis disappears**
         (1) In that case, the partnership adjusts it's basis

11) S Corporations –

- **a) Essentially a corporation that is treated similarly to a partnership for federal income tax purposes**
- **b) Shareholder requirements**
  - **i) Maximum of 100 shareholders (husband and wife count as only 1 as do up to six (6) generations of a family)**
  - **ii) Must be either individuals, estates, certain trusts, or pensions**
  - **iii) Individuals can not be non-resident aliens**
  - **iv) Thus, corporations can not own an S Corp, nor can partnerships**
  - **v) Testamentary trusts (decedent's estates) only for two years**
- **c) Corporate requirements**
  - **i) Domestic Corporation**
  - **ii) One class of stock (may vary voting rights)**
  - **iii) Not an ineligible corporation**
    - ***(1) Banks***
    - ***(2) Insurance companies***
    - ***(3) Corps electing the Puerto Rican tax credit***
  - **iv) Can own 100% of the stock in either an S Corporation or C Corporation subsidiary**
  - **v) Debt may constitute a second class of stock**
- **d) An S Corporation that has always been an S Corp is exempt from all taxes**
  - **i) Taxes will apply is the corporation was once a C Corporation if:**
  - **ii) Lifo - then it must recapture the LIFO**
    - ***(1) Tax is determined in the last C year by including all LIFO layers***
    - ***(2) Tax is spread out over the last C year and the following 3 years***
    - **(3) BIG - built in gains will be taxable as realized (limited to C corporation income**
    - **(4) Excess net passive income**
      - ***(a) If earnings and profits at the end of the year***
      - ***(b) Then, tax will apply to net passive income***
- **e) Election (Form 2553)**
  - **i) During the first 2 1/2 months applies for the whole year**
  - **ii) Each first year shareholder must sign the consent**
  - **iii) New shareholders (later years) consent is not needed**
- **f) Termination**
  - **i) Failure to meet the requirements**
    - ***(1) More than 100 shareholders***
    - ***(2) Ineligible shareholders – non resident aliens***
    - ***(3) Second class of stock***
    - ***(4) Failure of passive income test for three consecutive years***
      - (a) Excess 25% passive income (vs. gross receipts)
      - (b) E & P at the end of the year
  - **ii) Can elect to revoke**
    - ***(1) More than 1/2 the shareholders must vote to revoke***
    - ***(2) If made in first 2 1/2 months, is retroactive***
    - ***(3) If made later, can chose any date***

        (4) Must generally wait 5 years to re-elect

g) **Inadvertent termination**
    i) **IRS an waive if the shareholders fix the problem**
    ii) **IRS can fix defective elections**

h) **Taxable year**
    i) **Calendar year (Dec. 31)**
    ii) **Fiscal year if business purpose**
    iii) **Can make Section 444 election for up to three month deferral (Sept. Oct. or Nov.)**

i) **Taxable income and tax returns**
    i) **Generally the same as partnerships**
    ii) **Corporate carryovers (from prior C years, simply are held until the corporation becomes a C corporation again)**
    iii) **If appreciated property is distributed**
        (1) ***C Corp rules apply, and a taxable income applies***
            (a) ***Thus, not as good as a partnership***
        (2) **Built in Gains Tax (BIG)**
            (a) ***Applies when a C Corporation elects S status***
            (b) ***Essentially requires the corporation to determine FMV and compare to the basis of the assets***
            (c) ***As assets are sold the gain is taxed to the corporation***
            (d) ***Only applies for 10 years***

j) **Shareholder reporting**
    i) ***No special allocations as in partnership***
    ii) ***No guaranteed payments - employees exist as this is a corporation***
    iii) ***All income, deductions, etc. are allocated by stock ownership pro-rated on a daily basis***
        (1) Can use pro rate method (days)
        (2) Can elect to close the book at the time of a change
    iv) **Shareholder loss limitations**
        (1) **Limited to basis**
        (2) **Unlike partnerships, loans to the corporation do not add to basis**
        (3) **Shareholder loans to the corporation are considered basis by the shareholder who loaned the money**
        (4) **Thus, to get basis, shareholders must borrow directly from the bank and loan the loan to the S Corp.**
        (5) **Losses exceeding basis**
            (a) ***Carry over to future years***
            (b) ***In the case of a termination - can be taken if additional basis is "found" within one year (Post Termination Transition Period)***

k) **Basis**
   i) **Like a partnership is calculated at the end of each year**
   ii) **Original basis**
   iii) **Minus cash distributions**
   iv) **Plus or minus income or loss pass through**
   v) **Can include shareholder loans**

l) **Distributions - Always an S corporation or no E & P**
   i) **Tax free up to basis**
   ii) **Remainder is capital gains**

m) **Distributions - Once a C Corp and still E & P**
   i) **Tax free up to AAA (accumulated adjustments account)**
      (1) AAA is the net of income and deductions passed through to the shareholder, except
      (2) it does not include tax exempt income
   ii) **Next, dividend to the extent of E & P**
   iii) **Tax free up to other adjustments (tax-exempt income) and basis of stock**
   iv) **Capital Gain**
   v) **Can elect to bypass these rules and first distribute E & P**
      (1) Use this election if passive income for three years could cause a termination of the S election
      (2) Allows the corporation to hold other appreciated assets
      (3) Distribution of those assets would cause recognition of gain

n) **Fringe benefits**
   i) **Treated like a partnership, but 2% owners only**
   ii) **Thus, medical insurance passes through (not deductible by the corp)**

o) **Note, unlike partnerships, there is no Section 754 election, so outside basis will not equal inside basis on sales and death transfers**