

Limits on a partner's loss deductions

Dear Reader:

You recently asked about the tax implications of losses you expect to incur from your partnership.

As you are probably aware, one of the advantages of doing business as a partnership (or S corporation), as opposed to as a regular corporation, is that the business losses “pass through” to the partners and can be deducted by them on their individual tax returns. Many taxpayers are not aware, however, that limitations apply on how much of a partner's loss can be deducted.

The rule is you cannot take a loss on your individual tax return greater than your basis in your partnership interest. The loss is considered to occur on the last day of the partnership tax year, so the key figure is your basis in your interest as of that date. If you are aware of this limitation and of your basis, you may be able to do some planning to increase your allowable loss.

Your basis in your partnership interest starts out as the amount of cash you contribute, the basis you had in any property you contributed, and your share of partnership debt. (If you contribute property subject to debt, the rules get more complex.) After that, your basis is increased by your share of partnership income or gains and any later contributions you make to the partnership. Conversely, it is decreased by cash distributions you receive, by the basis of property distributed to you, and by your share of losses you are able to deduct.

Under these rules, if your share of partnership loss is \$10,000 but your basis in your partnership interest is only \$6,000, you will only be able to deduct \$6,000 of the loss. (The rest is carried forward into future years where it can be deducted as your basis increases sufficiently to cover it.)

If you anticipate being allocated a partnership loss that you will not be able to deduct, consider the following moves to increase your basis before the end of the partnership tax year.

1. Accelerate planned contributions to the partnership. If you are planning to contribute cash or property to the partnership at some point, make the contribution before year end. As noted above, contributions increase your basis in your interest by the amount of cash and the basis of property contributed. In this fashion, you may be able to, in effect, “buy” deductible losses.

2. Defer distributions from the partnership. If you expect a distribution from the partnership, consider having it deferred until after the end of the partnership year. Since a distribution reduces your basis, deferring it will leave you more basis to allow larger loss deductions. (Although the cash distributions in the next year will be taxable to the extent they exceed your basis, you may avoid the tax on advances against your share of partnership profits if your basis is increased by the end of the next year.)

3. Accelerate partnership borrowings. If the partnership is planning on increasing its borrowings, consider having the new loans taken out by the partnership before its year end. Since the increased partnership loans increase each partner's basis by his share of the debt, partners would be able to deduct more losses.

4. Change allocation of partnership liabilities. You may increase your basis by increasing the portion of the liabilities allocated to you. The rules for allocating liabilities are complex and depend on whether the liabilities are recourse or nonrecourse. However, the rules have some flexibility and it may be possible for you to be allocated a greater portion of the partnership's liabilities without incurring a significant risk of loss if the partnership becomes insolvent.

If you would like our help in implementing any of the above planning moves or would like to discuss this topic further, please give us a call.

