

Why a partner reports more income than he receives in cash

Dear Reader:

You recently asked why, in a given year, you may be taxed on more partnership income than was distributed to you from the partnership in which you are a partner.

The answer lies in the way partnerships and partners are taxed. Unlike a regular corporation, a partnership isn't subject to income tax. Rather, each partner is taxed on the partnership's earnings, whether or not they are distributed. Similarly, if a partnership has a loss, the loss is passed through to the partners. (Various rules, however, may prevent a partner from currently using his share of a 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 (Form 1065). On Schedule K of this form, the partnership separately identifies many items of income, deduction, credits, etc. This is so that each partner can properly treat items that are subject to limits or other rules that could affect their correct treatment at the partner's level. Examples of such items include capital gains and losses, charitable contributions, and interest expense on investment debts. Each partner gets a Schedule K-1 showing his share of partnership items.

Basis and distribution rules ensure that partners aren't taxed twice. A partner's initial basis in his partnership interest (the determination of which varies depending on how the interest was acquired) is increased by his 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. Rather, partners merely reduce their basis by the amount of the distribution. If a cash distribution exceeds a partner's basis, then the excess is taxed to the partner as a gain, which often is a capital gain.

Example: Smith and Jones each contributes \$10,000 to form a partnership. The partnership has \$80,000 of taxable income in Year 1, during which it makes no cash distributions to Smith or Jones. Smith and Jones each picks up \$40,000 of taxable income from the partnership as shown on their K-1s. Each has a starting basis of \$10,000, which is increased by \$40,000 to \$50,000. In Year 2, the partnership breaks even (has zero taxable income) and distributes \$40,000 to Smith and a like amount to Jones. The cash distributed to them is received tax-free. Each of them, however, must reduce the basis in his partnership interest from \$50,000 to \$10,000.

The discussion above is an overview and, therefore, does not touch on all the rules. For example, many other events require basis adjustments and there are a host of special rules covering noncash distributions, distributions of securities, liquidating distributions, and other matters.

Please call if you wish to further discuss any aspect of how you are taxed as a partner.

