

# 20 Partnerships and LLCs

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### Filing Deadline

**Form 1065, U.S. Return of Partnership Income.** The due date to file Form 1065 is the 15th day of the third month after the end of the partnership's tax year (March 15 for a calendar year partnership).

**Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc.** The partnership is required to provide Schedule K-1 to each partner on or before the day on which the partnership return is required to be filed (including extensions).

### Where to File

Form 1065 filing addresses, see *Where to File Business Returns*, page 24-1.

## ■ New for 2024 ■

- **Form 7217, Partner's Report of Property Distributed by a Partnership.** Form 7217 must be filed by a partner receiving non-liquidating or liquidating distributions of property. See *Form 7217, Partner's Report of Property Distributed by a Partnership*, page 20-17.

### Common Elections

- Election by spouses to be treated as a qualified joint venture instead of a partnership, page 20-5.
- Election to deduct or amortize start-up costs and organizational costs, page 20-8.
- Election out of partnership treatment by eligible investing partnerships or operating agreement groups, page 20-6.
- Election to adjust basis of partnership property under IRC section 754, page 20-16.
- Election out of centralized partnership audit regime, page 20-8.

### Business Activity Codes

See *Principal Business or Professional Activity Codes for Corporations and Partnerships*, page 25-6.

**Note:** The IRS frequently revises this list. Check each year for updates.

### Filing Requirements

**Partnerships.** Every partnership that engages in a trade or business, or has gross income, must file an information return on Form 1065, *U.S. Return of Partnership Income*, showing its income, deductions, and other required information.

**Limited Liability Companies (LLCs).** Entities formed as LLCs that are classified as partnerships for federal income tax purposes have the same filing requirements as domestic partnerships. See *Limited Liability Company (LLC)*, page 20-20.

### Extension of Time to File

**Automatic 6-month extension of time to file Form 1065.** Form 7004, *Application for Automatic Extension of Time To File Certain Business Income Tax, Information, and Other Returns*, is used by partnerships to extend the filing deadline for six months. No signature is required. For details on filing the form electronically, visit [www.irs.gov/efile7004](http://www.irs.gov/efile7004).

### Electronic Filing

**Mandatory electronic filing.** Partnerships are required to file Form 1065 and related forms and schedules electronically if they file 10 or more returns of any type during the tax year, including information, income tax, employment tax, and excise tax returns. Partnerships with more than 100 partners are required to file Form 1065, Schedule K-1, and related documents electronically. A waiver of the mandatory electronic filing requirement may be granted before the return is filed, if hardship is shown, and will be based on all facts and circumstances.

**Waiver request.** Guidance on waivers for partnerships unable to meet e-file requirements can be found at [www.irs.gov/e-file-providers/guidance-on-waivers-for-partnerships-unable-to-meet-e-file-requirements](http://www.irs.gov/e-file-providers/guidance-on-waivers-for-partnerships-unable-to-meet-e-file-requirements).

- IRS e-Help Desk: 866-255-0654.
- See *Electronic Filing*, page 18-2.

**E-file tax years.** For any given processing year, the IRS accepts e-filed tax returns for the most recent tax year and two prior tax years.

## Where to Report Income and Expenses (Form 1065)

Item	Description	Where to Report
<b>Capital gains and losses</b>	Gains or losses from assets held for investment by the partnership.	Compute on Form 8949 and carry to Schedule D (Form 1065). Gains or losses flow through on Schedules K and K-1 (Form 1065).
<b>Charitable contributions</b>	Partnership contributions to qualified charitable organizations.	Lines 13a and 13b, Schedule K, and box 13, Schedule K-1, Codes A through G.
<b>Cost of goods sold</b>	Amounts paid for raw materials and merchandise less ending inventory.	Computed on Form 1125-A. Deducted from partnership income on line 2, Form 1065.
<b>Dependent care benefits</b>	Amount paid on behalf of partnership employees for dependent care benefits.	Line 19, Form 1065, unless included in cost of goods sold on Form 1125-A.
	Amount paid on behalf of partners for dependent care benefits.	Line 13e, Schedule K, and box 13, Schedule K-1, Code O.
<b>Depreciation</b>	Assets purchased and placed in service by the partnership.	Form 4562. Depreciation is deducted from partnership income on line 16, Form 1065.
	Assets contributed by partners.	If FMV is different from the contributing partner's adjusted basis, enter positive adjustments on line 11, Schedule K, and box 11, Schedule K-1, Code F. Enter negative adjustments on line 13e, Schedule K, and box 13, Schedule K-1, Code V.
<b>Educational assistance benefits</b>	Amount paid on behalf of partnership employees for educational benefits.	Line 19, Form 1065, unless included in cost of goods sold on Form 1125-A.
	Amount paid on behalf of partners for educational benefits.	Line 13e, Schedule K, and box 13, Schedule K-1, Code N.
<b>Expenses from trade or business activities</b>	Does not include capitalized expenses, expenses incurred in nonbusiness rental activities, or cost of goods sold.	Page 1, Form 1065.
<b>Farm profit or loss</b>	Net profit or loss from farming other than farm rental activities.	Schedule F (Form 1040). Net profit or loss is carried to line 5, Form 1065.
<b>Guaranteed payments</b>	Payments to a partner that are not determined by profits. Includes amounts paid for health care for a partner, spouse, or dependent.	Line 10, Form 1065; also on lines 4a and/or 4b, Schedule K, and boxes 4a and/or 4b, Schedule K-1.
<b>Health insurance</b>	Premiums paid for partnership employees.	Line 19, Form 1065, unless included in cost of goods sold on Form 1125-A.
	Premiums paid for partner, spouse, or dependent.	Report as a guaranteed payment on line 10, Form 1065, and line 13e, Schedule K, and box 13, Schedule K-1, Code M.
<b>Income from trade or business activities</b>	Does not include rental income, interest, dividends, or other portfolio income.	Page 1, Form 1065.
<b>Investment expenses</b>	For purposes of computing deductible investment interest for partners.	Line 20b, Schedule K, and box 20, Schedule K-1, Code B.
<b>Investment income</b>	For purposes of computing deductible investment interest for partners.	Line 20a, Schedule K, and box 20, Schedule K-1, Code A.
<b>Investment interest expense</b>	Interest allocable to debt on property held for investment by the partnership.	Line 13c, Schedule K, and box 13, Schedule K-1, Code H.
<b>Limitation on business interest expense</b>	Partnerships required to file Form 8990 may have excess taxable income.	Line 20c, Schedule K, and Box 20, Schedule K-1, Code N (information item), and Codes AE and AF.
<b>Meals</b>	Meal expenses subject to the 50% limit under IRC section 274(n).	Allowable deduction is reported on line 21, Form 1065. Nondeductible portion is reported on line 18c, Schedule K and box 18, Schedule K-1, Code C.
<b>Organization costs</b>	Amounts attributable to creation of the partnership and chargeable to a capital account.	May be deducted, amortized, or capitalized. See <i>Start-Up Costs and Organizational Costs</i> , page 20-8.
<b>Qualified business income deduction (QBID)</b>	Information the partnership must supply to a partner for computing an IRC section 199A deduction.	Box 20, Schedule K-1. Use Code "Z*" and attach a statement. See <i>Section 199A information</i> , page 20-11.
<b>Rental income and expenses</b>	Rental real estate that is not a trade or business activity.	Form 8825; flows to line 2, Schedule K, and box 2, Schedule K-1.
	Rental activity other than rental real estate or rental as a trade or business activity.	Line 3, Schedules K and K-1.
<b>Retirement plan contributions</b>	Contributions to employees' retirement plans.	Line 18, Form 1065.
	Contributions made on behalf of partners.	Line 13e, Schedule K, and box 13, Schedule K-1, Code R.
<b>Sales of assets</b>	Assets used in trade or business activities.	Form 4797. Ordinary income from trade or business flows to line 6, Form 1065. Capital gain carried to Schedules K and K-1, Form 1065. See <i>Dispositions of property with Section 179 deductions</i> , page 20-10, if Section 179 was claimed.
	Assets used in rental activities.	Form 4797. Ordinary gains and losses are reported on Form 8825 or line 3, Schedule K, and box 3, Schedule K-1.
<b>Section 179 expense</b>	Expense for assets placed in service during the tax year.	Form 4562. Line 12, Schedule K, and box 12, Schedule K-1.
<b>Start-up costs</b>	Expenses paid or incurred before the start of business operations that would be deductible by an ongoing trade or business.	May be deducted, amortized, or capitalized. See <i>Start-Up Costs and Organizational Costs</i> , page 20-8.
<b>Tax-exempt interest</b>	Federally tax-exempt interest income, including any exempt-interest dividends from a mutual fund.	Line 18a, Schedule K, and box 18, Schedule K-1, Code A.

# Schedule K-1 Codes (Form 1065) — Partnership

**Note:** The 2024 Schedule K-1 (Form 1065) codes were not available at the time this publication went to print.

Listed below are the 2023 Schedule K-1 (Form 1065) codes.

Box Number / Item
1. Ordinary business income (loss). Determine whether the income (loss) is passive or nonpassive and enter on your return as follows.
Passive loss
Passive income
Nonpassive loss
Nonpassive income
2. Net rental real estate income (loss)
3. Other net rental income (loss)
Net income
Net loss
4a. Guaranteed payment services
4b. Guaranteed payment capital
4c. Guaranteed payment total
5. Interest income
6a. Ordinary dividends
6b. Qualified dividends
6c. Dividend equivalents
7. Royalties
8. Net short-term capital gain (loss)
9a. Net long-term capital gain (loss)
9b. Collectibles (28%) gain (loss)
9c. Unrecaptured section 1250 gain
10. Net section 1231 gain (loss)
11. Other income (loss)
Code A. Other portfolio income (loss)
Code B. Involuntary conversions
Code C. Section 1256 contracts & straddles
Code D. Mining exploration costs recapture
Code E. Cancellation of debt
Code F. Section 743(b) positive adjustments
Code G. Reserved for future use
Code H. Section 951(a) income inclusions
Code I. Gain (loss) from disposition of oil, gas, geothermal, or mineral properties (section 59(e))
Code J. Recoveries of tax benefit items
Code K. Gambling gains and losses
Code L. Any income, gain, or loss to the partnership from a distribution under section 751(b) (certain distributions treated as sales or exchanges)
Code M. Gain eligible for section 1045 rollover (replacement stock purchased by partnership)
Code N. Gain eligible for section 1045 rollover (replacement stock not purchased by the partnership)
Code O. Sale or exchange of QSB stock with section 1202 exclusion
Code P. Gain or loss on disposition of farm recapture property and other items to which section 1252 applies
Code Q. Gain or loss on Fannie Mae or Freddie Mac qualified preferred stock
Code R. Specially allocated ordinary gain (loss)
Code S. Non-portfolio capital gain (loss)

Box Number / Item
Codes T through X. Reserved for future use
Code ZZ. Other
12. Section 179 deduction
13. Other deductions
Code A. Cash contributions (60%)
Code B. Cash contributions (30%)
Code C. Noncash contributions (50%)
Code D. Noncash contributions (30%)
Code E. Capital gain property to a 50% organization (30%)
Code F. Capital gain property (20%)
Code G. Contributions (100%)
Code H. Investment interest expense
Code I. Deductions—royalty income
Code J. Section 59(e)(2) expenditures
Code K. Excess business interest expense
Code L. Deductions—portfolio income (other)
Code M. Amounts paid for medical insurance
Code N. Educational assistance benefits
Code O. Dependent care benefits
Code P. Preproductive period expenses
Code Q. Reserved for future use
Code R. Pensions and IRAs
Code S. Reforestation expense deduction
Codes T through U. Reserved for future use
Code V. Section 743(b) negative adjustments
Code W. Soil and water conservation
Code X. Film, television, and theatrical production expenditures
Code Y. Expenditures for removal of barriers
Code Z. Itemized deductions
Code AA. Contributions to a capital construction fund (CCF)
Code AB. Penalty on early withdrawal of savings
Code AC. Interest expense allocated to debt-financed distributions
Code AD. Interest expense on working interest in oil or gas
Code AE. Deductions—portfolio income
Codes AF through AJ. Reserved for future use
Code ZZ. Other
14. Self-employment earnings (loss)
Note. If you have a section 179 deduction or any partner-level deductions, see page 22 before completing Schedule SE (Form 1040).
Code A. Net earnings (loss) from self-employment
Code B. Gross farming or fishing income
Code C. Gross nonfarm income
15. Credits
Code A. Zero-emission nuclear power production

Box Number / Item
Code B. Production from advanced nuclear power facilities credit
Code C. Low-income housing credit (section 42(j)(5)) from post-2007 buildings
Code D. Low-income housing credit (other) from post-2007 buildings
Code E. Qualified rehabilitation expenditures (rental real estate)
Code F. Other rental real estate credits
Code G. Other rental credits
Code H. Undistributed capital gains credit
Code I. Biofuel producer credit
Code J. Work opportunity credit
Code K. Disabled access credit
Code L. Empowerment zone employment credit
Code M. Credit for increasing research activities
Code N. Credit for employer social security and Medicare taxes
Code O. Backup withholding
Code P. Unused investment credit from the qualifying advanced coal project credit or qualifying gasification project credit allocated from cooperatives
Code Q. Unused investment credit from the qualifying advanced energy project credit allocated from cooperatives
Code R. Unused investment credit from the advanced manufacturing investment credit allocated from cooperatives
Code S. Reserved for future use
Code T. Unused investment credit from the energy credit allocated from cooperatives
Code U. Unused investment credit from the rehabilitation credit allocated from cooperatives
Code V. Advanced manufacturing production credit
Codes W and X. Reserved for future use
Code Y. Clean hydrogen production credit
Code Z. Orphan drug credit
Code AA. Enhanced oil recovery credit
Code AB. Renewable electricity production credit
Code AC. Biodiesel, renewable diesel, or sustainable aviation fuels credit
Code AD. New markets credit
Code AE. Credit for small employer pension plan startup costs
Code AF. Credit for small employer auto-enrollment
Code AG. Credit for small employer military spouse retirement plan eligibility
Code AH. Credit for employer-provided childcare facilities and services
Code AI. Low sulfur diesel fuel production credit
Code AJ. Qualified railroad track maintenance credit
Code AK. Credit for oil and gas production from marginal wells
Code AL. Distilled spirits credit

Box Number / Item
Code AM. Energy efficient home credit
Code AN. Alternative motor vehicle credit
Code AO. Alternative fuel vehicle refueling property credit
Code AP. Clean renewable energy bond credit
Code AQ. New clean renewable energy bond credit
Code AR. Qualified energy conservation bond credit
Code AS. Qualified zone academy bond credit
Code AT. Qualified school construction bond credit
Code AU. Build America bond credit
Code AV. Credit for employer differential wage payments
Code AW. Carbon oxide sequestration credit
Code AX. Carbon oxide sequestration credit recapture
Code AY. New clean vehicles credit
Code AZ. Qualified commercial clean vehicle credit
Code BA. Credit for small employer health insurance premiums
Code BB. Employer credit for paid family and medical leave
Code BC. Eligible credits from transferor(s) under section 6418
Codes BD through BG. Reserved for future use
Code ZZ. Other
17. Alternative minimum tax (AMT) items
Code A. Post-1986 depreciation adjustment
Code B. Adjusted gain or loss
Code C. Depletion (other than oil & gas)
Code D. Oil, gas, and geothermal—gross income
Code E. Oil, gas, and geothermal—deductions
Code F. Other AMT items
18. Tax-exempt income and nondeductible expenses
Code A. Tax-exempt interest income
Code B. Other tax-exempt income
Code C. Nondeductible expenses
19. Distributions
Code A. Cash and marketable securities
Code B. Distribution subject to section 737
Code C. Other property
20. Other information
Code A. Investment income
Code B. Investment expenses
Code C. Fuel tax credit information
Code D. Qualified rehabilitation expenditures (other than rental real estate)
Code E. Basis of energy property

continued on next page

**Schedule K-1 Codes (Form 1065)—Partnership continued**

Box Number / Item	Box Number / Item
Code F. Recapture of low-income housing credit for section 42(j)(5) partnerships	Code AE. Excess taxable income
Code G. Recapture of low-income housing credit for other partnerships	Code AF. Excess business interest income
Code H. Recapture of investment credit	Code AG. Gross receipts for section 448(c)
Code I. Recapture of other credits	Code AH. Noncash charitable contributions
Code J. Look-back interest—completed long-term contracts	Code AI. Interest and tax on deferred compensation to partners
Code K. Look-back interest—income forecast method	Code AJ. Excess business loss limitation
Code L. Dispositions of property with section 179 deductions	Code AK. Gain from mark-to-market election
Code M. Recapture of section 179 deduction	Code AL. Section 721(c) partnership
Code N. Business interest expense (information item)	Code AM. Section 1061 information
Code O. Section 453(l)(3) information	Code AN. Farming and fishing business
Code P. Section 453A(c) information	Code AO. PTP information
Code Q. Section 1260(b) information	Code AP. Inversion gain
Code R. Interest allocable to production expenditures	Code AQ. Conservation reserve program payments
Code S. Capital construction fund (CCF) nonqualified withdrawals	Code AR. IRA disclosure
Code T. Depletion deduction	Code AS. Qualifying advanced coal project property and qualifying gasification project property
Code U. Section 743(b) basis adjustment	Code AT. Qualifying advanced energy project property
Code V. Unrelated business taxable income	Code AU. Advanced manufacturing investment property
Code W. Precontribution gain (loss)	Code AV. Reserved for future use
Code X. Payment obligations including guarantees and deficit obligations (DROs)	Code AW. Reportable transactions
Code Y. Net investment income	Code AX. Reserved for future use
Code Z. Section 199A information	Code AY. Foreign partners, Form 8990, Schedule A
Code AA. Section 704(c) information	Codes AZ through BD. Reserved for future use
Code AB. Section 751 gain (loss)	Code ZZ. Other
Code AC. Section 1(h)(5) gain (loss)	
Code AD. Deemed section 1250 unrecaptured gain	21. Foreign taxes paid or accrued

**Foreign Transactions Reporting**

**Foreign income.** Schedule K-2 (Form 1065), *Partners’ Distributive Share Items—International*, and Schedule K-3 (Form 1065), *Partner’s Share of Income, Deductions, Credits, etc.—International*, report the partnership’s foreign transactions. See *Schedules K-2 and K-3 (Form 1065)*, page 20-11.

**Foreign assets.** Domestic partnerships must file Form 8938, *Statement of Specified Foreign Financial Assets*, with Form 1065 if the total value of foreign financial assets was more than \$50,000 on the last day of the tax year, or more than \$75,000 at any time during the tax year. See *Foreign Accounts and Trusts*, page 6-4.

**Digital Assets**

All partnerships must answer a digital assets question (Question 30, Schedule B) when filing Form 1065.

*At any time during this tax year, did the partnership (a) receive (as a reward, award, or payment for property or services), or (b) sell, exchange, or otherwise dispose of a digital asset (or financial interest in a digital asset)?*

**Penalties**

**Late filing.** The penalty for failing to file a partnership return by the due date, including extensions, or filing a return that fails to show all the information required, is \$245 for each month or part of a month the failure continues times the number of partners, up to 12 months.

**Schedule K-1.** A \$330 penalty applies for each failure to timely issue Schedule K-1 to a partner or failure to provide required information. The penalty may be increased if the failure to provide the schedule is intentional.

**Reasonable cause.** Penalties, above, may be waived for reasonable cause. The partnership (or any of its partners) may qualify for reasonable cause as a small partnership if all the following conditions are met.

- The partnership had no more than 10 partners for the taxable year. A married couple filing a joint return count as one partner.
- Each partner was a natural person (other than a nonresident alien), or the estate of a natural person.
- Each partner’s proportionate share of any partnership item was the same as their proportionate share of any other partnership item.
- The partnership elected out of the centralized partnership audit regime. See *Electing out of the centralized partnership audit regime*, page 20-8.
- All partners reported their distributive share of partnership items on their timely filed income tax returns.

For details, see Rev. Proc. 84-35 (continues to apply per PMTA-2020-1).

**Amended Partnership Return**

The procedures for filing an amended partnership return depend on whether the amended return is filed electronically or on paper. The rules for determining when a return must be filed electronically also apply to amended returns. See *Electronic Filing*, page 20-1.

**Electronic.** Complete Form 1065 and check box G(5) to indicate an amended return. Attach a statement that identifies the line number of each amended item, the corrected amount or treatment of the item, and an explanation of the reason(s) for each change. If the information provided to any partner on Schedule K-1 is incorrect, file an amended Schedule K-1 for that partner with the amended Form 1065 and give a copy of the amended Schedule K-1 to the partner. Check the “Amended K-1” box at the top of the schedule.

**Exception:** A partnership that is subject to the Bipartisan Budget Act of 2015 (BBA) centralized partnership audit regime must file Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, to request an administrative adjustment in the amount of one or more partnership-related items rather than an amended return. See *Centralized Partnership Audit Regime*, page 20-8.

**Paper.** If the amended return will not be filed electronically, complete Form 1065-X, *Amended Return or Administrative Adjustment Request (AAR)*. If the corrected amount involves an item of income, deduction, or credit that must be supported with a schedule, statement, or form, attach the supporting document to Form 1065-X.

**Correcting a Previously Filed Form 1065**

Type of return eligible for correction	Electronic filer	Paper filer
Superseding return (filed within original filing period, including extensions)	Yes	Yes
Amended return—BBA partnership*	No	N/A
Amended return—non-BBA partnership*	Yes	Yes
Administrative Adjustment Request (AAR) for BBA partnership*	Yes—Form 8082 with Form 1065	Yes—Form 1065-X
Partner modification amended return (tiered partnerships)	Yes—Form 1065	Yes—Form 1065-X

\* BBA partnerships are subject to the centralized partnership audit regime. See *Centralized Partnership Audit Regime*, page 20-8.

continued on next page



## Partnership Advantages/Disadvantages

Advantages	Disadvantages
<p><b>Flexibility.</b> A partnership can make special allocations or distributions among partners for non-pro-rata shares of income and deductions.</p> <p><b>Simplicity.</b> For tax purposes, a formal partnership agreement is not required (a written partnership agreement is recommended. See <i>Business Agreements</i>, page 27-5, for information about written partnership agreements). A verbal agreement is generally all that is required to form a partnership.</p> <p><b>Flow-through income.</b> Income and deductions from a partnership flow through to the partners.</p>	<p><b>Liability.</b> A general partner is liable for debts of the partnership, including debts that have been incurred by another person. An LLC formed under state law can shield partners from liability.</p> <p><b>Self-employment tax.</b> The distributive share of income from a partnership is subject to SE tax for general partners.</p> <p><b>Commitment.</b> It is often said that a partnership is easier to get into than to get out of. Written partnership agreements should contain an escape clause.</p>

For more information about the advantages and disadvantages of different business entities, see *Business Entity Comparison Chart*, page 27-3.

For a comparison of partnership attributes with S corporation attributes, see *LLC Treated as Partnership vs. S Corporation* chart, page 20-21.

## Partnerships

### Cross References

- Form 1065, *U.S. Return of Partnership Income*
- IRS Pub. 541, *Partnerships*
- IRC §701 – 761

### Related Topics

- Part II—Partnerships and S Corporations, page 7-2
- Business Entity Comparison Chart, page 27-3
- Business Agreements, page 27-5

### Partnership Defined

An unincorporated organization with two or more members is a partnership by default for federal tax purposes if its members carry on a trade, business, or financial operation and divide profits.

**Co-ownership.** Co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

**Sharing expenses.** A joint undertaking merely to share expenses is not a partnership.

**General partnership.** A general partnership is composed of only general partners. A general partner is a partner who is personally liable for partnership debts.

**Limited partnership.** A limited partnership is formed under a state's limited partnership law and composed of at least one general partner and one or more limited partners.

**Limited liability partnership (LLP).** An LLP is formed under state law. Generally, a partner in an LLP is not personally liable for the acts or omissions of any other partner, solely by reason of being a partner. See *Limited Liability Partnership (LLP)*, page 20-22.

**Limited liability company (LLC).** An LLC is an entity formed under state law. An LLC with at least two members is classified

as a partnership for federal tax purposes unless the entity files Form 8832, *Entity Classification Election*, to elect to be taxed as a corporation. See *Limited Liability Company (LLC)*, page 20-20.

**Anti-abuse rule.** If, based on all of the facts and circumstances, a partnership appears to be formed for the principal purpose of substantially reducing the partners' federal tax liability with no bona fide business purpose, the partnership may be disregarded and the claimed tax benefits disallowed. (Reg. §1.701-2)

**Entity classification election.** For information on entity classification elections, see *Entity Classification Election*, page 18-17.

### Spousal Partnerships

Generally, if spouses jointly own and operate an unincorporated business and share the profits and losses, they are partners in a partnership and must file Form 1065.

**Qualified joint venture election.** If spouses materially participate as the only members of a jointly owned and operated business, and they file a joint return for the tax year, they can elect to be treated as a qualified joint venture instead of a partnership. The filing of Form 1065 is not required for any year the election is in effect.

A qualified joint venture is one where:

- The only members of the joint venture are spouses,
- Both spouses materially participate in the trade or business,
- The business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or LLC, and
- Both spouses elect to have the provision apply.

To make the election, divide all items of income, gain, loss, deduction, and credit between spouses in accordance with their respective interests in the venture. Each spouse must file a separate Schedule C (Form 1040) or Schedule F (Form 1040). Each spouse must also file a separate Schedule SE (Form 1040) to pay self-employment tax. Once made, the election cannot be revoked without IRS consent.

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**Author's Comment:** An LLC owned only by a married couple in a community property state may be treated as a qualified joint venture. (Rev. Proc. 2002-69)

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### Partnership Interests Created by Gift

**Gift of capital interest.** If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to both of the following restrictions.

- It must be computed by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

**Purchase considered gift.** For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital.

For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

### Contribution of Services

A partner can acquire an interest in partnership capital or profits as compensation for services performed.

**Capital interest.** A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. The fair market value of services rendered in exchange for a capital interest in a partnership is taxable to the partner as a guaranteed payment and deductible by the partnership. The partner is then treated as contributing the guaranteed payment back to the partnership in exchange for a partnership interest. The partnership does not recognize gain or loss on the transfer.

**Profits interest.** A profits interest is a partnership interest other than a capital interest. The receipt of a profits interest for providing services to a partnership in a partner capacity is not taxable to the partner or the partnership unless:

- The profits interest relates to a substantially certain and predictable stream of income from partnership assets,
- The partner disposes of the profits interest within two years of receipt, or
- The profits interest is a limited partnership interest in a publicly traded partnership.

A profits interest transferred as compensation for services is not subject to the rules for restricted property that apply to capital interest.

## Exclusion From Partnership Treatment

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes. All the partners must agree to make the choice, and the partners must be able to compute their own taxable income without computing the partnership's income.

The partners are not exempt from the rule that limits a partner's distributive share of partnership loss to the adjusted basis of the partner's interest in the partnership. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year.

**Investing partnerships.** A partnership that engages in the joint purchase and sale of investment property may elect out of partnership treatment. To be eligible:

- The partners must own the property as co-owners.
- The partners must reserve the right to dispose of their shares of the property.
- The partnership may not engage in the active conduct of trade or business.

**Operating agreement groups.** A partnership that engages in the joint production, extraction, or use of property may elect out of partnership treatment. To be eligible:

- The partners must own the property as co-owners.
- The partners must reserve the right to separately dispose of their shares of any property produced or extracted.
- The partners must not jointly sell services or property produced or extracted.

**Election out of partnership treatment.** An eligible organization that wishes to be completely excluded from partnership treatment must make the election no later than the time for filing, including extensions, the partnership return for the first tax year for which the exclusion is desired. [Reg. §1.761-2(b)]

To make the election, file a blank Form 1065 with a statement attached containing:

- Names, addresses, and TINs of all the members of the organization.
- A statement that the organization qualifies under Regulation section 1.761-2(a)(2) [investing partnership] or Regulation section 1.761-2(a)(3) [operating agreement].

- A statement that all the members of the organization elect that it be excluded from all of Subchapter K.
- A statement indicating where a copy of the agreement under which the organization operates is available.

**Did You Know?** Even with a valid exclusion from partnership treatment in place, a business can be treated as a partnership under certain sections of the tax code. For example, in *Cokes, 91 T.C. No. 222*, the court found that even though an operating agreement group had a valid election out of partnership treatment, income to a recipient was subject to self-employment (SE) tax on distributive share of partnership income. From the court case: "The election under section 761(a) does not operate to change the nature of the entity. A partnership remains a partnership; the exclusion simply prevents the application of Subchapter K. The partnership remains intact and other sections of the Code are applicable as if no exclusion existed."

**Partial election out of partnership treatment.** A partnership may be allowed to elect out of certain provisions of partnership rules by filing a request with the IRS. [Reg. §1.761-2(c)]

## General and Limited Partners

**General partner.** A general partner is a partner who is personally liable for partnership debts. A general partner is subject to SE tax on guaranteed payments and on the distributive share of partnership income.

**Limited partner.** A limited partner is liable only for the amount of money or other property that the partner contributed, or is required to contribute, to the partnership. A limited partner is subject to SE tax on guaranteed payments but is not subject to SE tax on the distributive share of income.

**LLC members.** An LLC with more than one owner is treated as a partnership by default unless the LLC elects to be taxed as a corporation. Members of an LLC are subject to SE tax on guaranteed payments, but uncertainty exists as to whether and when LLC members are subject to SE tax on the distributive share of income. The IRS has ruled that members treated as general partners in an LLC are subject to SE tax on their distributive share of the LLC's income. Members treated as limited partners in an LLC are not subject to SE tax on their distributive share of the LLC's income. (CCA 201436049)

For more information about the questions surrounding SE tax for LLC members, see *Limited partners vs. LLC members*, page 20-20.

**Designated partnership representative.** Unless the partnership has made a valid election out of the centralized partnership audit regime, it must designate a partner, or other person with a substantial presence in the United States, as the partnership representative who shall have the sole authority to act on behalf of the partnership. If an entity is designated as partnership representative, the partnership must also appoint an individual to act on the entity's behalf (a designated individual).

The partnership must include information regarding the partnership representative and/or designated individual (if applicable) on Form 1065 (Schedule B). See *Centralized Partnership Audit Regime*, page 20-8.

## Fundamentals of Partnership Taxation

**Flow-through income and deductions.** A partnership does not pay income tax at the entity level. Income, losses, deductions, and credits from a partnership flow through and are reported on the partners' tax returns. Where individuals are partners, partnership rules are designed to treat items the same on the individual return as they would be if reported directly by the individual. For example, if two individuals operate a trade or business as a partnership, net profit has the same effect on their returns as if

the income were reported on the individual's Schedule C (Form 1040) and Schedule SE (Form 1040).

**Example:** George operates a business as a sole proprietorship. His net profit from self-employment in 2023 was \$35,000, which he reported as ordinary income on Schedule C and also on Schedule SE. Joy also owns a sole proprietorship. Her profit from self-employment in 2023 was \$65,000, which she reported as ordinary income on Schedule C and also on Schedule SE.

On January 1, 2024, George and Joy decided to go into business together and form a partnership. Both will be general partners. Based on the amount invested by each, and in keeping with their partnership agreement, George's distributive share of income is 35%, and Joy's is 65%. For 2024, assume the same amount of net profit as in 2023. The partnership's net profit for 2024 is \$100,000 (\$35,000 + \$65,000).

Partnership profit for 2024.....	\$100,000
Passed through to George at 35% distributive share.....	\$ 35,000
Passed through to Joy at 65% distributive share.....	\$ 65,000

George and Joy each report their distributive share of partnership profit as ordinary income on their Forms 1040, and the amounts are subject to SE tax. This results in the same gross income and amount subject to SE tax as each had in 2023.

**Reporting pass-through income.** Income and deductions from a partnership flow through to partners on Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* See *Schedules K and K-1 (Form 1065)*, page 20-27.

The following fundamentals apply with respect to a partner reporting partnership income.

- Income or loss from the partnership is reported on the partner's tax return whether or not the amounts have been distributed.
- Distributions from a partnership are generally not taxable to the partner up to the partner's adjusted basis in the partnership interest.
- Distributive share of income from a partnership increases the partner's basis in the partnership interest.
- Distributive share of losses from a partnership decreases the partner's basis in the partnership.

See *Partner's Basis in the Partnership (Outside Basis)*, page 20-13, and *Partnership Distributions*, page 20-17.

**Example:** Gordie is a partner in Deerwalk Partnership. His basis in the partnership at the end of 2022 was \$800. For 2023, Schedule K-1 reported Gordie's share of partnership income as \$1,200. Gordie received no distributions from the partnership in 2023. He reported the \$1,200 as taxable income in 2023 even though he received no distributions.

On January 6, 2024, Gordie took a distribution of \$1,800 cash from the partnership. His distributive share of income from the partnership for 2024 was \$150. The distribution of \$1,800 cash is not taxable to Gordie.

Basis in partnership interest, 12/31/22.....	\$ 800
Distributive share of income (taxable), 2023.....	<u>1,200</u>
Adjusted basis, 12/31/23.....	\$2,000
Cash distribution (not taxable), 2024.....	(1,800)
Distributive share of income, 2024.....	<u>150</u>
Adjusted basis, 12/31/24.....	\$ 350

**Reporting partner's share of income or loss.** Income or loss from a partnership's trade or business activities are netted as "Ordinary business income (loss)" on line 23, Form 1065. The partner's share of ordinary income or loss flows through to the partner's individual return based on the partner's distributive share. If there is no special allocation contained within the partnership agreement, the partner's distributive share equals the

partner's percentage of ownership interest in the partnership. See *Distributive Share*, page 20-9.

Individual partners generally report income or loss from trade or business activities on Part II, page 2, Schedule E (Form 1040). Losses are subject to at-risk rules and passive loss limitations. For information about at-risk rules, see *At-Risk Rules*, page 7-12. For information about passive loss limitations, see *Passive Activity Losses*, page 7-7. Amounts subject to self-employment (SE) tax are also reported on Schedule SE (Form 1040). For information about SE tax, see *Self-Employment Tax*, Tab 5.

**SE tax.** A general partner's distributive share of business income is subject to SE tax if the partner is an individual. A limited partner's distributive share of business income is not subject to SE tax. Guaranteed payments are subject to SE tax for both general and limited partners. See *Guaranteed Payments*, page 20-9.

**Qualified opportunity fund.** To be certified as a qualified opportunity fund (QOF), the partnership must file Form 1065 and attach Form 8996, *Qualified Opportunity Fund*, even if the partnership had no income or expenses to report. See *Qualified Opportunity Zone (QOZ)*, page 18-13.

## Partnership Agreement

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the agreement. The agreement or modifications can be oral or written.

Partners can modify the agreement for a particular tax year after the close of the year but before the original due date of the partnership return. This filing date does not include any extension of time. If the agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement. For more information, see *Business Agreements*, page 27-5.

## Partnership Tax Year

**Required tax year for partnerships.** A partnership must generally conform its tax year to its partners' tax years. The rules for determining the required tax year are as follows.

**Majority interest tax year.** If one or more partners having the same tax year own an interest in partnership profits and capital of more than 50% (majority interest), the partnership must use the tax year of those partners.

**Principal partner.** If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.

**Least aggregate deferral of income.** If there is no majority interest tax year, and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners. For rules on least aggregate deferral of income, see IRS Pub. 538, *Accounting Periods and Methods*.

**Exceptions to required tax year.** A partnership does not have to use a required tax year under any of the following situations.

- The partnership makes an IRC section 444 election.
- The partnership elects to use a 52–53 week tax year that ends with reference to either its required tax year or a tax year elected under IRC section 444.
- The partnership can establish a business purpose tax year.

See *Election Other Than Required Taxable Year (IRC §444)*, Tab 19.



## Centralized Partnership Audit Regime

The centralized partnership audit regime applies to all partnerships unless the partnership is an eligible partnership and it elects out by making a valid election using Schedule B-2 (Form 1065), *Election Out of the Centralized Partnership Audit Regime*.

**Partnership audit rules.** Any adjustment made during a partnership audit to items of income, gain, loss, deduction, credit, or other partnership-related item is assessed and collected at the partnership level. Any penalty, addition to tax, or additional amount that relates to an adjustment made during a partnership audit is also determined at the partnership level. Any increase in tax as a result of the audit is paid by the partnership in the year the audit is finalized at the highest rate of tax in effect for the reviewed year (37% for 2024). (IRC §6225)

Additionally, the partnership must designate a partnership representative who shall have sole authority to act on behalf of the partnership. See *Designated partnership representative*, page 20-6.

**Electing out of the centralized partnership audit regime.** A partnership can elect out of the centralized partnership audit regime for a tax year if the partnership is an eligible partnership that year.

The election is made annually on the eligible partnership's timely filed return, including extensions, for the tax year to which the election applies. Include the following information on Schedule B-2 (Form 1065) and file with the tax return.

- The name of each partner.
- The taxpayer identification number (TIN) of each partner.
- The federal tax classification for each partner.
- If an S corporation is a partner, provide the names, TINs, and federal tax classification of any shareholder of the S corporation for the tax year of the S corporation ending with or within the partnership's tax year.

**Revoking the election.** This annual election may not be revoked without the consent of the IRS.

**Eligible partnership.** A partnership is an eligible partnership for a tax year if it has 100 or fewer eligible partners.

The determination as to whether the partnership has 100 or fewer partners is made by adding the number of Schedules K-1 required to be issued by the partnership to the number of Schedules K-1 required to be issued by any partner that is an S corporation to its shareholders for the tax year of the S corporation ending with or within the partnership tax year.

A partnership is not an eligible partnership if it is required to issue a Schedule K-1 to any of the following partners.

- A partnership.
- A trust.
- A foreign entity that would not be treated as a C corporation were it a domestic entity.
- A disregarded entity that has a single owner (other than a bank) and is not a corporation.
- An estate of an individual other than a deceased partner.
- Any person that holds an interest in the partnership on behalf of another person.

**Eligible partner.** A partner is an eligible partner if it is an individual, C corporation, foreign entity that would be treated as a C corporation if it was domestic, S corporation, or an estate of a deceased partner.

**Partner notification.** A partnership that elects out of the centralized partnership audit regime must notify each of its partners of the election within 30 days of making the election.

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**Author's Comment:** Situations in which a partnership might want to elect out of the centralized partnership audit regime rules could include the following.

- A partnership with partners in lower tax brackets who do not want to pay tax on increased partnership income at the highest tax rate,
  - A partnership with partners who want to retain their rights to object or disagree with the results of a partnership audit, or
  - A partnership which has added new partners or had partners leave during the years in question.
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## Partnership Income and Expenses

### Cross References

- IRS Pub. 535, *Business Expenses*
- IRS Pub. 541, *Partnerships*
- IRC §702, *Income and credits of partner*
- Notice 2020-75

### Related Topics

- Self-employed health insurance deduction, Tab 5
- Business Deductions, Tab 8
- Business Agreements, page 27-5

### Trade or Business Income (Loss)

Income and deductions from partnership trade or business activities are reported on page 1, Form 1065. Net ordinary income or loss is reported on line 23, Form 1065. Ordinary income or loss is passed through to the partners according to the partners' distributive share of income.

**Did You Know?** The hobby-loss not-for-profit activity limitation of IRC section 183 applies to partnerships (Rev. Rul. 77-320). See *Hobby Loss Rules* Tab 5.

### Start-Up Costs and Organizational Costs

**Election.** A partnership may elect to deduct up to \$5,000 of start-up costs and \$5,000 of organizational costs in the year it begins business. The deduction is phased out dollar-for-dollar when start-up costs (or organizational costs) exceed \$50,000. Remaining costs must be amortized over a 180-month period. In lieu of the deduction, taxpayers may elect to amortize all costs. See *Start-Up/Organization Costs*, page 8-22.

**Start-up costs.** Start-up costs are amounts paid or incurred for creating or investigating the creation or purchase of an active trade or business. The costs are incurred before the active trade or business begins.

**Organizational costs.** The costs to organize a partnership are direct costs of creating the partnership. An organizational cost must meet the following tests.

- It is for the creation of the partnership and not for starting or operating the partnership trade or business.
- It is chargeable to a capital account.
- It could be amortized over the life of the partnership if the partnership had a fixed life.
- It is incurred by the due date of the partnership return (excluding extensions) for the first tax year in which the partnership is in business. **Exception:** See *Cash method partnership*, page 20-9.
- It is for a type of item normally expected to benefit the partnership throughout its entire life.



Qualifying Costs	Nonqualifying Costs
<ul style="list-style-type: none"> <li>• Legal fees incident to the organization of the partnership, such as negotiation and preparation of the partnership agreement.</li> <li>• Accounting fees incident to the organization of the partnership.</li> <li>• Filing fees.</li> </ul>	<ul style="list-style-type: none"> <li>• Acquiring assets for the partnership or transferring assets to the partnership.</li> <li>• Admitting or removing partners, other than at the time the partnership is first organized.</li> <li>• Making a contract concerning the operation of the partnership business including a contract between a partner and the partnership.</li> <li>• Syndication fees for issuing and marketing interests in the partnership.</li> </ul>

**Cash method partnership.** A partnership using the cash method of accounting can deduct an organizational cost only if it has been paid by the end of the tax year. Any cost the partnership could have deducted in an earlier tax year, if it had been paid that year, can be deducted in the year of payment.

**Liquidation of partnership.** If a partnership is liquidated before the end of the amortization period, the unamortized amount can be deducted in the partnership's final tax year to the extent the costs qualify as a loss from a business.

For more information, see *Start-Up/Organization Costs*, page 8-22.

## Distributive Share

The partnership agreement generally determines a partner's distributive share of any item of income, gain, loss, deduction, or credit. If the partnership agreement does not provide for an allocation, the distributive share is equal to the partner's percentage of ownership interest in the partnership.

**Special allocations.** A partnership agreement can allocate partnership items in percentages other than according to the partners' ownership interests. However, an allocation will be disregarded if it does not have substantial economic effect. An allocation has substantial economic effect if both the following tests are met.

- There is a reasonable possibility that the allocation will substantially affect the dollar amount of the partners' shares of partnership income or loss, independent of tax consequences.
- The partner to whom the allocation is made actually receives the economic benefit or bears the economic burden corresponding to that allocation.

**Allocation attributable to a nonrecourse liability.** An allocation of a loss, deduction, or expense attributable to a partnership nonrecourse liability does not have any economic effect because the partner does not bear the economic burden corresponding to that allocation. Therefore, the partner's distributive share of the item must be determined by his or her interest in the partnership (Reg. §1.704-2). See *Effect of Partnership Liabilities*, page 20-14.

## Distributive Share vs. Guaranteed Payments

Distributive Share	<ul style="list-style-type: none"> <li>• Allocation based on ownership % unless specially allocated.</li> <li>• Subject to SE tax for general partners.</li> <li>• Not deductible by partnership.</li> </ul>
Guaranteed Payments for Services	<ul style="list-style-type: none"> <li>• Payments for services rendered.</li> <li>• Subject to SE tax.</li> <li>• Deductible to partnership.</li> </ul>
Guaranteed Payments for Capital	<ul style="list-style-type: none"> <li>• Payments for use of capital.</li> <li>• Not subject to SE tax.</li> <li>• Deductible by partnership.</li> </ul>

## Guaranteed Payments

Guaranteed payments are payments made to partners without regard for the profit or loss from partnership activities. Guaranteed payments are deducted from partnership income in determining the distributive share of income or loss passing through to partners.

**Payments for services.** Guaranteed payments for services are generally based on services rendered and are similar to wages of a shareholder-employee of a corporation.

**Example:** Rachel and Kendall each contribute \$30,000 to a partnership and each becomes a 50% owner. During the year, Rachel works 1,000 hours on partnership business, and Kendall works 400 hours on partnership business. Guaranteed payments will equal \$15 per hour for each partner. For the year, the partnership earns \$40,000 in net profits before deducting guaranteed payments.

Rachel's guaranteed payment for the year is \$15,000, and Kendall's is \$6,000. Of the remaining \$19,000 (\$40,000 profit – \$15,000 – \$6,000), each partner receives \$9,500 as a distributive share (\$19,000 × 50%).

The guaranteed payments allow the partnership to compensate Rachel for a greater amount of work without any special allocations of partnership net income.

**Author's Comment:** It is not uncommon to see partnerships pay partners as employees, withhold taxes, and issue W-2 forms at the end of the year. However, according to Rev. Rul. 69-184, a partner should not be treated as an employee of a partnership and is not subject to employee withholding for FICA, FUTA, or federal income tax. Partners should be compensated with guaranteed payments.

**Minimum payment.** If a partner is to receive a minimum payment from the partnership, the guaranteed payment is the amount by which the minimum payment is more than the partner's distributive share of the partnership income before taking into account the guaranteed payment.

**Example:** Under a partnership agreement, John is to receive 30% of the partnership income, but not less than \$8,000. The partnership has a net income of \$20,000. John's share, without taking the guaranteed payment into account, is \$6,000 (\$20,000 × 30%). John's guaranteed payment is \$2,000 (\$8,000 minimum payment minus \$6,000 distributive share). If the partnership's income was \$30,000, there would have been no guaranteed payment because John's distributive share would have been \$9,000 (\$30,000 × 30%).

**Self-employed health insurance premiums.** Premiums for health insurance paid by a partnership on behalf of a partner for services rendered are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include the payments in gross income. See *Health insurance in the name of the individual*, Tab 5.

**Payments for capital.** A guaranteed payment for capital is any payment to a partner that is determined without regard to partnership income and is for the use of that partner's capital. Guaranteed payments made to partners for organizing the partnership or syndicating interests in the partnership are capital expenses.

**Payments resulting in loss.** If guaranteed payments to a partner result in a partnership loss in which the partner shares, the partner must report the full amount of the guaranteed payments as ordinary income. The partner separately takes into account his or her distributive share of the partnership loss, to the extent of the adjusted basis of the partner's partnership interest.

## Business Interest Expense Limitation

The business interest expense deduction may be limited for certain taxpayers, unless an exception is met. [IRC §163(j)]

The law places limits on the deduction for interest paid on business debt for taxpayers with average annual gross receipts in excess of \$30 million (2024). The deduction for business interest is limited to the sum of:

- Business interest income for the tax year,
- 30% of the adjusted taxable income (ATI) of the taxpayer (but not below zero), and

*continued on next page*

- The floor plan financing interest of the taxpayer for the tax year. Floor plan financing interest means interest paid on debt used to finance the acquisition of certain motor vehicles held for sale or lease and secured by the inventory of such motor vehicles that are acquired.

**Business interest income or expense.** Business interest income or expense means the amount of interest includible in the taxpayer's gross income or that is paid or accrued for the year that is properly allocable to a trade or business. Business interest expense does not include investment interest expense. Business interest income does not include investment income.

**Adjusted taxable income (ATI).** For purposes of the business interest deduction limitation, ATI means the taxable income of the taxpayer computed without regard to:

- Any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
- Any business interest expense or business interest income,
- The amount of any net operating loss deduction,
- The amount of any deduction allowed under IRC section 199A (see *Section 199A information*, page 20-11),
- In the case of tax years beginning before 2022, any deduction allowable for depreciation, amortization, or depletion, and
- Any other adjustments described in regulations to be issued by the IRS.

For purposes of determining ATI, taxable income is computed after applying other sections limiting the deductibility of interest as well as basis, at-risk, and passive activity loss limitations. Any additions or subtractions from taxable income in arriving at ATI are limited to the amount by which the item affects taxable income.

**Carryforward of disallowed expense.** If the limitation applies, the amount of any business interest expense that is not allowed as a deduction for the current tax year is generally carried forward to the following year. Special rules apply to partnerships.

**Partnerships.** The business interest limitation is applied at the partnership level and any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership.

A partner carries forward his or her share of excess business interest expense. In a succeeding taxable year, a partner may treat its excess business interest expense as an expense paid or accrued by the partner to the extent the partner is allocated excess taxable income or excess business interest income from the same partnership. Once excess business interest expense is treated as an expense paid or accrued by the partner, such business interest expense is subject to the partner's section 163(j) limitation.

**Form 8990. Limitation on Business Interest Expense Under Section 163(j).** Generally, a taxpayer with business interest expense, a disallowed business interest expense carryforward, or current or prior year excess business interest expense must file Form 8990, unless an exclusion applies.

**Pass-through entity.** A pass-through entity that is not a small business taxpayer and is allocating excess taxable income or excess business interest income to its owners must file Form 8990 regardless of whether it has any interest expense.

**Small business.** A small business taxpayer is not subject to the business interest limitation and is not required to file Form 8990. A small business taxpayer is a taxpayer that is not a tax shelter, and has average annual gross receipts of \$30 million or less for the three prior tax years.

## Meals and Entertainment Expense

**Meals expense.** A taxpayer can deduct 50% of the cost of business meals. See *Meals*, page 8-9.

**Entertainment expense.** No deduction is allowed for entertainment expense with respect to:

- An activity generally considered to be entertainment, amusement, or recreation,
- Membership dues with respect to any club organized for business, pleasure, recreation, or other social purposes, or
- A facility or portion thereof used in connection with any of the above items.

See *Entertainment*, page 8-9.

## State and Local Taxes Paid

The IRS issued guidance for individual owners of partnerships or S corporations in calculating their state and local tax (SALT) deduction limitations. The notice states that if an entity makes a payment to a state, a political subdivision of a state, or the District of Columbia to satisfy its liability for income taxes imposed by the state or local government, the entity is allowed a deduction for such payment in computing its taxable income. The deduction is allowed without regard to whether the imposition of and liability for the income tax is the result of an election by the entity, or whether the partners or shareholders receive a partial or full deduction, exclusion, credit, or other tax benefit that is based on their share of the amount paid by the entity. (Notice 2020-75)

The tax payment made by an entity does not constitute a separately stated item for determining the partner's or shareholder's federal income tax liability. Instead, the tax payment is reflected in a partner's or shareholder's distributive or pro rata share of non-separately stated income or loss reported on Schedule K-1. As a result, a tax payment made to a state or local government by the entity is not taken into account in applying the \$10,000 (\$5,000 MFS) limitation to any individual who is an owner of the entity.

The guidance in Notice 2020-75 and corresponding proposed regulations is effective for entity tax years ending after December 31, 2017 and before January 1, 2026.

**Note:** Most states refer to this deduction as the pass-through entity (PTE) tax.

See *Pass-Through Entity (PTE) Election* chart, Tab 17.

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**Author's Comment:** Notice 2020-75 states that the deduction is allowed in computing the entity's taxable income for the taxable year in which the payment is made. The notice does not address whether an entity using the accrual method of accounting is allowed to deduct taxes that have been accrued but not paid until after the close of the tax year.

## Separately Stated Partnership Items

Certain items may be treated differently among partners depending on their individual tax situations. Items such as capital gains or losses, charitable contributions, and Section 179 expense deductions are stated separately on the partner's Schedule K-1 to ensure proper computation on the individual return.

**Capital gains or losses.** Partnerships use Form 8949, *Sales and Other Dispositions of Capital Assets*, to report the sale or exchange of assets held for investment. Totals from Form 8949 are carried to Schedule D (Form 1065). Gains or losses flow through to partners on Schedules K and K-1, line 8 (short term) or Schedules K and K-1, line 9a (long term).

**Dispositions of property with Section 179 deductions.** Special rules apply if any property is disposed of by a pass-through entity (PTE) for which Section 179 was deducted. Instead of the PTE reporting on Forms 4797, 6252, 4684, or 8824, each partner or shareholder will report on such forms using information flowing through on Schedule K-1. The following information should be reported by the PTE for each sale.

- Description of property.
- Date the property was acquired and placed in service.



- Date of the sale or other disposition of the property.
- Partner's or shareholder's share of gross proceeds or amount realized.
- Partner's or shareholder's share of the cost or other basis, plus selling expenses.
- Partner's or shareholder's share of allowed or allowable depreciation exclusive of Section 179 deduction.
- Partner's or shareholder's share of any Section 179 expense deduction and years to which the amounts were passed through.
- If the disposition is due to casualty or theft, a statement indicating so and any additional information required by the partner-shareholder to complete Form 4684, *Casualties and Thefts*.
- If the disposition was an installment sale, any information required by the partner-shareholder to complete Form 6252, *Installment Sale Income*.
- If the disposition was property given up in a like-kind exchange, any information required by the partner-shareholder to complete Form 8824, *Like-Kind Exchanges*.

Disposition of property may result in a reduction of unused Section 179 deduction carried over by the partners or shareholders. See the instructions for Form 4797, *Sales of Business Property*, for a worksheet that computes gain or loss on such dispositions.

**Character of pass-through items.** Income or losses passing through from a partnership retain their character. The partner is required to treat items passing through from a partnership in the same manner as the item was treated by the partnership. For example, rental income earned by the partnership is passed through and reported as rental income by the partner.

**Charitable contributions.** All partnerships generally must file Form 8283, *Noncash Charitable Contributions*, if noncash contributions exceed \$500. The partnership must attach a copy of its Form 8283 to the Schedule K-1 of each partner if the deduction for any item or group of similar items of contributed property exceeds \$5,000, even if the amount allocated to any partner is \$5,000 or less.

**Section 199A information.** The qualified business income deduction (QBID), also known as the IRC section 199A deduction, is determined at the partner level where the partner is an individual, trust, or estate. The partnership should enter Code Z with an asterisk (Z\*) on line 20 of each partner's Schedule K-1 and enter "STMT" in the space to indicate that the information is provided on an attached statement that separately identifies the partner's distributive share of:

- Qualified items of income, gain, deduction, and loss,
- Form W-2 wages,
- Unadjusted basis immediately after acquisition (UBIA) of qualified property (see *Unadjusted basis (UBIA) of qualified property*, page 8-18,
- Qualified publicly traded partnership (PTP) items, and
- Section 199A dividends, also known as qualified real estate investment trust (REIT) dividends.

The partnership makes an initial determination of which items are qualified items of income, gain, deduction, and loss at its level and reports to each partner its distributive share of all items that may be qualified items at the partner level. The partner must then determine whether each item is includible in qualified business income.

Additionally, the partnership must report whether any of its trades or businesses are specified service trades or businesses (SSTBs) and identify any trades or businesses that are aggregated. See *Specified Service Trade or Business (SSTB)*, page 8-17.

**Required statements.** These statements can be found in the instructions for Form 1065.

- **Statement A—QBI Pass-Through Entity Reporting.** Partnerships use *Statement A*, or a substantially similar statement, to report information for each partner's distributive share from each

trade or business by attaching the completed statement(s) to each partner's Schedule K-1.

- **Statement B—QBI Pass-Through Entity Aggregation Election(s).** Use *Statement B*, or a substantially similar statement, to report aggregated trades or businesses and provide supporting information to partners on each Schedule K-1.
- **Statement C—QBI Pass-Through Entity Reporting—Patrons of Specified Agricultural and Horticultural Cooperatives.** Use *Statement C*, or a substantially similar statement, to report the distributive share of qualified business income and Form W-2 wages allocable to qualified payments from a specified agricultural or horticultural cooperative for each trade or business.

**Determining the partnership's qualified trades or businesses.** The partnership's qualified trades or businesses include any activity carried on to make a profit and with considerable, regular, and continuous activity. See *Qualified Trades or Businesses*, page 8-15, and *Qualified Business Income (QBI)*, page 8-17.

**Rental real estate.** Rental real estate may constitute a trade or business for purposes of the QBID if the rental real estate:

- Rises to the level of a trade or business under IRC section 162,
- Satisfies the requirements for the rental real estate safe harbor (see *Rental real estate safe harbor*, page 7-3, or
- Meets the self-rental exception of the rental or licensing of property to a commonly-controlled trade or business conducted by an individual or relevant pass-through entity. [Reg. § 1.199A-1(b)(14)]

Rental real estate that does not meet any of these three conditions does not constitute a trade or business for purposes of the QBID and must not be included in the qualified business income information provided to partners.

More information can be found under *Qualified Business Income Deduction (QBID)—IRC §199A*, page 8-15.

## Schedules K-2 and K-3 (Form 1065)

Schedule K-2 (Form 1065), *Partners' Distributive Share Items – International*, is an extension of Form 1065 (Schedule K) and is used to report items of international tax relevance from the operation of a partnership. Items of international tax relevance include foreign source income, assets generating foreign source income, ownership in certain types of foreign entities, and foreign taxes paid or accrued.

Schedule K-3 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.—International*, is an extension of Schedule K-1 (Form 1065) and is used to report to partners their share of items reported on Schedule K-2.

A partnership filing Schedules K-2 and K-3 is only required to complete the relevant portions. For more information, see [www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865](http://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865).

**Domestic filing exception.** A domestic partnership that meets the following four criteria does not need to file Schedules K-2 and K-3 with the IRS or furnish Schedule K-3 to a partner (except when requested).

- 1) **No or limited foreign activity.** Foreign activity is restricted to passive category income with \$300 or less of foreign taxes paid or accrued, and the foreign income must be reported to the partnership on a payee statement such as Form 1099-DIV.
- 2) **U.S. citizen/resident alien partners.** All direct partners must be either a U.S. citizen, a resident alien, a domestic decedent's estate with only U.S. citizen/resident alien beneficiaries, a domestic grantor/non-grantor trust with only U.S. citizen/resident alien grantors and beneficiaries, an S corporation with a sole shareholder, or a single-member LLC (disregarded entity) whose sole member is one of the persons mentioned above.



- 3) **Partner notification.** A partnership that satisfies criteria (1) and (2), above, must notify partners at the latest when the partnership furnishes the Schedule K-1 to the partner. The notice can be provided as an attachment to the Schedule K-1. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request it.
- 4) **No K-3 requests by the 1-month date.** The partnership must not receive a request for Schedule K-3 from any partner on or before the 1-month date.

**1-month date.** The 1-month date is one month before the due date (including extension) of the partnership's tax return (Form 1065). For calendar year partnerships, the 1-month date is generally February 15, or the latest 1-month date is August 15 if the partnership files an extension.

**Request after the 1-month date.** If a partnership receives a request from a partner for Schedule K-3 after the 1-month date and has not received a request from any other partner on or before the 1-month date, the domestic filing exception is met. The partnership must provide Schedule K-3 to the requesting partner, but is not required to file Schedules K-2 or K-3 with the IRS or furnish Schedule K-3 to any non-requesting partners.

**Form 1116 exemption exception.** A partnership receiving notification that all partners are exempt from filing Form 1116, *Foreign Tax Credit*, is not required to complete Schedules K-2 and K-3 if the partnership receives notification of the partners' eligibility for such exemption by the 1-month date (as defined above). If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 with respect to the other partners to the extent that the partnership does not qualify for the domestic filing exception. A partnership that does not receive sufficient notification from a partner regarding exemption must presume the partner is eligible to claim a foreign tax credit, and does not meet the Form 1116 exemption exception.

**Other filing situations.** The instructions for Form 1065 provide examples of other filing situations for Schedule K-2 and Schedule K-3. For examples of completed schedules, see *Schedules K-2 and K-3 (Form 1120-S)*, in the S Corporation Example, Tab 19.

### Limit on Losses

A partner's distributive share of partnership loss may be limited by one of the following:

- Hobby Loss Rules, Tab 5.
- Passive Activity Losses, page 7-7.
- At-Risk Rules, page 7-12.
- Partner's adjusted basis, see *Partner's Basis in the Partnership (Outside Basis)*, page 20-13.

**Limitation on losses.** Excess business losses of a taxpayer other than a corporation must be carried forward. An excess business loss is the amount by which the total deductions from the taxpayer's trade or business exceed the taxpayer's gross income or gains from such trade or business, plus a threshold amount. The threshold amount for 2024 is \$305,000 (\$610,000 MFJ).

**Partners.** In the case of a partnership, the provision applies at the partner level. Each partner's pro rata share of items of income, gain, deduction, or loss are taken into account in applying the limitation for the taxable year.

This loss limitation applies after the application of the at-risk and passive loss rules. See *Excess Business Loss Limitation*, Tab 5.

**Related party loss limitations.** No deduction is allowed for losses from sales or exchanges of property (other than an interest in a partnership), directly or indirectly between:

- A partnership and a person owning, directly or indirectly, more than 50% of the capital interests or profits interest of the partnership, or
- Two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital interests or profits interests.

If the purchaser sells the property at a later date, gain is recognized to the extent that gain exceeds the previously disallowed loss.

### Timing of Income

For information on partnership fiscal year limitations, see *Required tax year for partnerships*, page 20-7.

**Accrual-basis payment to cash-basis partner.** An accrual-basis taxpayer may not deduct an expense accrued to a cash-basis related party until the amount has been included in the income of the recipient. [IRC §267(a)(2)]

### Change in Partnership Interest

The ownership percentage of partners can fluctuate during the year because of additional capital contributions, liquidation of a partner's interest, entry of a new partner, etc. Partnership items passing through to partners must reflect any changes in ownership interests that occurred during the year. If there is no special allocation spelled out on the partnership agreement, the shares of partnership items are based on the percentage of ownership of each partner and the time held during the year. The computation is similar to the per-share-per-day method of allocating S corporation income to shareholders. See *Pro-Rata Allocation/Per-Share/Per-Day*, Tab 19.

**Example:** On January 1, 2024, Randy and Julie were equal partners in RJ Partnership. On April 1, 2024, Eric joined the partnership as 20% owner. The partnership agreement allocates partnership items to be distributed to partners based on their ownership interests. During 2024, RJ Partnership had \$96,000 of ordinary income, which was earned evenly throughout the year. The partners' distributive shares of income are computed as follows.

	Ownership Interest		Percentage of Year Held		Partnership Income	Partner's Distributive Share
Randy.....	50%	×	25%	×	\$96,000	\$12,000
	40%	×	75%	×	\$96,000	28,800
Julie.....	50%	×	25%	×	\$96,000	12,000
	40%	×	75%	×	\$96,000	28,800
Eric.....	20%	×	75%	×	\$96,000	14,400
Total.....						\$96,000

**Closing the books.** Under the general rule, for purposes of determining distributive share upon sale, exchange, or liquidation of a partner's entire interest in a partnership, the partnership's tax year shall close with respect to the departing partner. This leaves the partner with a distributive share of items attributable only to the time the partner owned the partnership interest. [IRC §706(c)(2)(A)]

**Note:** A partnership taxable year with respect to a partner who dies shall not close prior to the end of the partnership year.

In order to avoid an interim closing of the books, the departing partner's distributive share of items may be estimated by taking the partner's pro rata part of what would have been included in taxable income had the partner remained until the end of the tax year. Any reasonable method may be used to determine the pro rata portion. This method of determining distributive share requires the agreement of all the partners. (Reg. §1.706-4)

### Unreimbursed Partnership Expenses

Under the general rule, a partner is not allowed to deduct partnership expenses on his or her individual tax return. However,

an exception applies when there is a provision in the partnership agreement requiring the partner to pay the expenses, or if payment of the expenses is a routine partnership practice tantamount to an agreement. See *Partnership Agreement*, page 20-7.

Allowable expenses are deducted on Part II, Schedule E (Form 1040). Report allowable unreimbursed partnership expenses as a separate item from partnership income on line 28, Schedule E. Enter "UPE" as the name of the line item, then list the amount on (i) of line 28. The expense will be deducted from partnership income and will also reduce net income subject to self-employment tax.

For an example of how to report unreimbursed partnership expenses, see the illustration of Schedule E of the *Partnership Example*, page 20-32.

**Author's Comment:** Include the requirement that the partners pay specific expenses in the written partnership agreement to help ensure deductibility in case of a challenge by the IRS. Also include wording that the partnership will not reimburse partners for the expenses.

**Court Case:** The taxpayer could not deduct expenses incurred as a partner, as these were expenses he chose to incur rather than expenses required to be incurred under the partnership agreement. Additionally, the expenses were eligible for reimbursement by the partnership and therefore not deductible as unreimbursed partnership expenses. (*Peter A. McLaughlan*, 5th Cir., March 6, 2014)

**Business use of the home.** Partners report expenses for business use of the home as unreimbursed partnership expenses on line 28, Schedule E (Form 1040). Do not use Form 8829, *Expenses for Business Use of the Home*, for a partner's expenses. Instead use the worksheet in IRS Pub. 587, *Business Use of Your Home*. See *Reporting Expenses for Business Use of the Home*, Tab 5.

**Note:** A shareholder of an S corporation does not have a similar provision for deducting unreimbursed corporate expenses on Schedule E. If the shareholder pays an expense on behalf of the corporation without reimbursement, the expense may be non-deductible. See *Paying Expenses of an Employer*, page 8-13.

## Basis

### Cross References

- IRS Pub. 541, *Partnerships*
- IRC §83, *Property transferred in connection with performance of services*
- IRC §722, *Basis of contributing partner's interest*
- IRC §723, *Basis of property contributed to partnership*
- IRC §754, *Manner of electing optional adjustment to basis of partnership property*

### Related Topics

- At-Risk Rules, page 7-12

### Partnership's Basis (Inside Basis)

The partnership's basis in its assets is known as inside basis. In addition to contributions of property, the partnership may acquire property by means of purchase.

Generally, the partnership's basis in contributed property is the same as the adjusted basis of the property in the hands of the contributing partner at the time of the contribution. Similarly, the partnership has a holding period in the property which dates back to the contributor's acquisition of the property. The partnership depreciates the contributed property as if the partner still held the property.

**Example:** O'Houlihan was a restaurant owner who operated as a sole proprietor. On June 1, 2022, O'Houlihan purchased a computer for use in his business at a cost of \$900. The computer has a MACRS recovery period of five years.

On January 1, 2024, O'Houlihan formed a partnership with MacScottigan. O'Houlihan contributed his computer in exchange for his partnership interest. The depreciation on the computer is deducted as follows:

Year	Basis	MACRS Percentage	Deducted on O'Houlihan's Form 1040	Deducted on the partnership's Form 1065
2022	\$900	20.00%	\$180	
2023	\$900	32.00%	\$288	
2024	\$900	19.20%		\$173
2025	\$900	11.52%		\$104
2026	\$900	11.52%		\$104
2027	\$900	5.76%		\$51

O'Houlihan and MacScottigan Partnership's holding period for the computer began on June 1, 2022.

### Partner's Basis in the Partnership (Outside Basis)

A partnership interest is an item of property. Like any other item of property, it has a basis for tax purposes. A partner's basis in his or her partnership interest is referred to as outside basis. Upon formation of the partnership, a partner's initial outside basis will generally equal the amount of money and the adjusted basis of property contributed. If the partner purchases his or her partnership interest, the outside basis will equal the purchase price.

### Basis Increases/Decreases

#### A partner's basis is increased by the following:

- The partner's additional contributions to the partnership.
- The partner's increased share of or assumption of partnership liabilities.
- The partner's distributive share of taxable and nontaxable partnership income.
- The partner's distributive share of the excess of the deductions for depletion over the basis of the depletable property, unless the property is oil or gas wells whose basis has been allocated to partners.

#### A partner's basis is decreased (but never below zero) by the following:

- The money and adjusted basis of property distributed to the partner by the partnership.
- The decrease in a partner's share of partnership liabilities, or assumption of the partner's individual liabilities by the partnership.
- The partner's distributive share of the partnership losses (including capital losses).
- The partner's distributive share of non-deductible partnership expenses that are not capital expenditures.
- The partner's share of any Section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return. See *Section 179 Deduction*, page 9-7.
- The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
- The partner's distributive share of foreign taxes paid or accrued by the partnership.<sup>1</sup>
- The partner's distributive share of adjusted basis of partnership's property donated to charity.<sup>1,2</sup>

<sup>1</sup> For tax years beginning after 2017.

<sup>2</sup> If the property's fair market value exceeds its adjusted basis, the basis limitation rule on partner losses does not apply to the extent of the partner's distributive share of the excess.

**Contribution of property.** No gain or loss is recognized to a partnership, or to any of its partners, when property is contributed to the partnership in exchange for a partnership interest. (IRC §721)

**Partner's liabilities assumed by partnership.** If contributed property is subject to a debt, or if a partner's liabilities are assumed by the partnership, the basis of that partner's interest is reduced (but not below zero) by the liability assumed by the other partners. The partner contributing the property must reduce his or her basis in the partnership because the assumption of the liability is treated as a distribution of money to that partner. The other partners' assumption of the liability is treated as a contribution by them of money to the partnership. See *Effect of Partnership Liabilities*, below.

**Negative basis.** Outside basis functions to ensure that over the partnership's life, the partner does not withdraw more or less than his or her investment without tax impact. Basis cannot be reduced below zero. A distribution of money to a partner in excess of his or her outside basis results in a recognized gain. [IRC §731(a)]

**Book value of partner's interest.** The adjusted basis of a partner's interest is determined without considering any amount shown in the partnership books as a capital, equity, or similar account.

### Effect of Partnership Liabilities

A partner's basis in a partnership interest includes the partner's share of partnership liabilities if the liability:

- Creates or increases the partnership's basis in any of its assets,
- Gives rise to a current deduction to the partnership, or
- Is a nondeductible, noncapital expense of the partnership.

**Increases.** If a partner's share of partnership liabilities increases, or a partner's individual liabilities increase because he or she assumes partnership liabilities, the increase is treated as a contribution of money by the partner to the partnership.

**Decreases.** If a partner's share of partnership liabilities decreases, or a partner's individual liabilities decrease because the partnership assumes his or her individual liabilities, the decrease is treated as a distribution of money to the partner by the partnership.

**Assumption of liability.** A partner or related person is considered to assume a partnership liability only to the extent that:

- The partner is personally liable for the debt,
- The creditor knows that the liability was assumed by the partner or related person,
- The creditor can demand payment from the partner or related person, and
- No other partner or person related to another partner will bear the economic risk of loss on that liability immediately after the assumption.

**Related person.** Related persons for these rules include, but are not limited to, the following.

- An individual and his or her spouse, ancestors, and lineal descendants.
- An individual and a corporation if the individual directly or indirectly owns 80% or more in value of the outstanding stock of the corporation.
- Two corporations that are members of the same controlled group.
- A grantor and a fiduciary of any trust.
- A partnership and a person owning, directly or indirectly, 80% or more of the capital or profits interests.

For a more detailed list, see IRS Pub. 541, *Partnerships*.

**Partner's share of recourse liabilities.** A partnership liability is a recourse liability to the extent that any partner or a related person has an economic risk of loss. A partner's share of a recourse liability equals his or her economic risk of loss for that liability. A partner has an economic risk of loss if that partner, or a related person, would be obligated to make a net payment to

the creditor or a contribution to the partnership if the partnership were constructively liquidated.

**Qualified nonrecourse financing.** A partnership liability that is qualified nonrecourse financing secured by real property used in the activity of holding real property is treated as an amount at risk.

**Partner's share of nonrecourse liabilities.** A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability. A partner's share of nonrecourse liabilities is generally proportionate to his or her share of partnership profits. However, this rule may not apply if the partnership has taken deductions attributable to nonrecourse liabilities or the partnership holds property that was contributed by a partner.

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**Author's Comment:** Under general basis rules, recourse and nonrecourse liabilities will increase a partner's basis in the partnership, but only recourse and qualified nonrecourse financing liabilities will increase a partner's at-risk basis. The at-risk rules limit deductible losses to the amount at risk in the activity.

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### Alternative Rule for Computing Partner's Basis

In certain cases, the adjusted basis of a partnership interest can be computed by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated. This alternative rule can be used in either of the following situations.

- The circumstances are such that the partner cannot practicably apply the general basis rules, or
- It is, in the opinion of the IRS, reasonable to conclude that the result produced will not vary substantially from the result under the general basis rules.

Adjustments may be necessary in computing the basis of a partnership interest under the alternative rule. For example, adjustments would be required to include any significant discrepancies that resulted from contributed property, transfers of partnership interest, or distributions of property to the partners. [Reg. §1.705-1(b)]

**Example:** Erica and Donna are 50/50 partners in the Flora Tax Office Partnership. They have been conducting business for years without maintaining capital accounts, basis calculations, or preparing balance sheets because income was always too low to require filling out Form 1065 (Schedule L). Unfortunately, the tax office partnership profits dwindle, and eventually losses are reported. The partners need to reconstruct basis to determine treatment of losses on their individual returns. Assume the following partnership items.

Cash.....	\$ 1,000
Equipment (adjusted basis after depreciation).....	10,000
Liabilities .....	(3,000)
Total.....	\$ 8,000

Under the alternative rule for computing partners' basis, Erica and Donna each have a basis in their partnership interest of \$4,000.

### Partner's Capital Account

Each partner's equity in the partnership is reflected in a capital account.

Generally, capital accounts reflect the FMV of assets at the time of contribution and distribution. The capital accounts show the partners' economic interest in the partnership.

The balance sheet reported on the partnership return reflects the total capital accounts of all partners. The recorded amount for each partner's capital account is generally in proportion to their respective interest in the partnership, but irregular distributions and special allocations of income may result in disproportionate capital balances. See *Special allocations*, page 20-9.



**Tax capital reporting requirement.** Partnerships must report capital account balances in Item L, Schedule K-1 (Form 1065) using tax basis. A partner's tax basis capital account represents partnership equity using the tax basis method, as opposed to GAAP, §704(b) book value, or other accounting methods.

Partnerships that meet the following four conditions, provided in question 4 on Form 1065 (Schedule B), are not required to report tax basis capital information, as these partnerships are not required to complete Item L on Schedule K-1 (Form 1065).

- Total receipts for tax year were less than \$250,000.
- Total assets at end of tax year were less than \$1 million.
- Schedules K-1 are filed with the return and furnished to partners on or before due date (including extensions).
- The partnership is not filing and is not required to file Schedule M-3.

**Alternative methods.** In order to assist partnerships that had not historically maintained tax basis information, the IRS provided three alternative methods of calculating tax basis capital.

- **Modified outside basis method.** Tax capital is calculated using the partner's outside tax basis amount, reduced by the partner's allocable share of partnership liabilities and net IRC section 743(b) adjustments. If the partnership is using this method for tax capital reporting, partners must notify the partnership in writing within 30 days of the end of each taxable year of any changes to partners' outside basis that are not reported on Schedule K-1. See *Partners' Basis in the Partnership (Outside Basis)*, page 20-13.
- **Modified previously taxed capital method.** Tax capital is calculated using a modified version of the partner's share of previously taxed capital. (Notice 2020-43)
- **Section 704(b) method.** Tax capital is calculated using the partner's IRC section 704(b) capital account balance, and is adjusted by the partner's share of built-in gain or loss on partnership assets. (Notice 2020-43)

**Reporting partnership events and transactions.** If the partnership is unsure of how to report a specific event or transaction under the tax capital reporting rules, it should account for the event or transaction using the following guidelines.

- Report in a manner consistent with computing the partner's adjusted tax basis in its partnership interest.
- The event or transaction should be reported without regard to partnership liabilities.
- Follow tax basis rules.
- Report the net effect of the event or transaction for each partner on the line for Other increase (decrease), Item L, Schedule K-1.

The partner's ending capital account as reported using the tax basis method may not equal the partner's adjusted tax basis in its partnership interest. Generally, this is because a partner's adjusted tax basis includes the partner's share of partnership liabilities, as well as partner specific adjustments. Each partner is responsible for maintaining a record of the adjusted tax basis in its partnership interest.

**Capital account vs. outside basis.** The capital account is not the same as basis. See *Partner's Outside Basis Compared to Partner's Capital Account* chart, page 20-16.

For example, when partners contribute noncash property, basis and capital will differ. Capital account balances and basis must be calculated independently. The capital account is calculated as follows.

- Initial FMV contribution,
- Plus additional capital contributions,
- Plus ratable allocations of income including special allocations),
- Minus ratable distributions of capital,
- Minus ratable allocations of losses (including special allocations).

The partners' share of liabilities is not included in the capital account, although it does increase basis.

**Schedule K-1.** Item L of Schedule K-1 (Form 1065) shows an analysis of changes in the partner's capital account for the tax year.

**Allocations to account for built-in gain or loss.** When the FMV of property at the time it is contributed to the partnership is different from the partner's adjusted basis, the partnership must allocate among the partners any income, deduction, gain, or loss on the property that will account for the difference.

**Traditional method of allocation.** Under the traditional method of allocation, if the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. [Reg. §1.704-3(b)]

**Example:** Jenny contributes \$50,000 in cash to Jenny Paul Partnership, and Paul contributes land with a FMV of \$50,000 and an adjusted basis of \$30,000 (built-in gain). The capital account is \$50,000 for each partner, and the partnership's adjusted basis in the land is \$30,000.

The partnership later sells the land for \$60,000. The \$30,000 gain on the land is allocated for tax purposes as follows:

Total gain.....	\$30,000
Built-in gain to Paul.....	20,000
Gain remaining.....	\$10,000
<i>50/50 split</i>	
Jenny.....	\$ 5,000
Paul.....	\$ 5,000
<i>Allocation of total gain</i>	
Jenny.....	\$ 5,000
Paul.....	\$25,000

The capital account is adjusted the same for Jenny and Paul. However, the allocation made under IRC section 704(c) shifts taxable income for the built-in gain on the property to Paul.

If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allocable to the partnership or the gain or loss realized by the partnership. [Reg. §1.704-3(b)(2)–Example 1]

**Example:** Bruce and Tom form a 50/50 partnership. Bruce contributes \$10,000 in cash and Tom contributes depreciable property with a FMV of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Tom's hands, which is \$4,000.

In effect, Bruce purchased a one-half interest in the depreciable property with his contribution of \$10,000 to the partnership. For purposes of this illustration, assume a depreciation rate of 10% per year. Under regular depreciation principles, Bruce would have been entitled to depreciation of \$500 for the year (\$10,000 × 10% = \$1,000 × 50% = \$500). However, because the depreciable basis in the property is only \$4,000, no more than \$400 can be allocated between the partners.

The entire \$400 in depreciation is allocated to Bruce.

The partnership can use different allocation methods for different items of contributed property. However, a single reasonable method must be consistently applied to each item, and the overall combination of methods must be reasonable.

See Regulations section 1.704-3(c), *Traditional method with curative allocations* and section 1.704-3(d), *Remedial allocation method*, for examples of other methods accepted by the IRS for allocating built-in gain or loss for property contributed to a partnership.

**Distribution of property to another partner within seven years.** If a partner contributes property to a partnership, and the partnership distributes the property to another partner within

seven years of the original contribution, the contributing partner must recognize gain or loss equal to the amount of built-in gain or loss at the time of contribution.

**Distribution to contributing partner within seven years.** If a partner contributes built-in gain property to a partnership, and within seven years that partner receives distributions from the partnership in excess of the partner's basis, the partner must recognize gain. The amount recognized is the lesser of the amount of built-in gain at the time of contribution, or the amount by which the distribution exceeded the partner's basis in the partnership. (IRC §737)

## Partner's Outside Basis Compared to Partner's Capital Account

	Outside Basis	Capital Account
Description	Adjusted basis of the partner's partnership interest.	Partner's equity investment in the partnership.
Additional contributions	Increase.	Increase.
Distributions	Decrease. <sup>1</sup>	Decrease.
Distributive share of income	Increase.	Increase.
Distributive share of losses	Decrease. <sup>1</sup>	Decrease.
Book value adjustments to partnership property	No effect. <sup>2</sup>	Can be increased or decreased by adjustments to book value of partnership property. <sup>3,4</sup>
Partnership liabilities	Any increase or decrease in a partner's allocable share of partnership liabilities will increase or decrease the partner's outside basis. <sup>1</sup> (IRC §752)	A partner's capital account is neither increased nor decreased by partnership liabilities.
Negative basis	A partner's outside basis may never go below zero. <ul style="list-style-type: none"> <li>• Deductions in excess of outside basis are not permitted. [IRC §704(d)]</li> <li>• A partner must recognize gain to the extent that distributions of money would reduce his or her outside basis below zero. [IRC §731(a)(1)]</li> </ul>	A partner is permitted to have a negative capital account as a result of his or her distributive share of losses or by distributions. This negative amount typically represents the amount of cash the partner would owe the partnership upon liquidation.

<sup>1</sup> A partner's outside basis may never be decreased below zero.

<sup>2</sup> The outside basis of a partner contributing property to a partnership is increased by his or her basis in the contributed property regardless of its FMV.

<sup>3</sup> The capital account of a partner contributing property to a partnership is increased by the property's FMV at the time of the contribution, regardless of the partner's basis in the property.

<sup>4</sup> Although certain adjustments are allowed by regulations, the method of adjusting the capital account must have substantial economic effect. [Reg. §1.704-1(b)(2)(iv)(d)]

## IRC Section 754 Election to Adjust Basis of Partnership Property

An election is available that allows a partnership to adjust the basis of partnership property upon distribution of property (IRC §734) or when the transfer of a partnership interest occurs (IRC §743). The election can address inequities that occur when partnership interests are sold or transferred and the FMV of property is different from the adjusted basis.

**Making the election.** The IRC section 754 election is made by attaching a written statement to Form 1065 filed by the due date, including extensions. The statement must include the name and

address of the partnership, be signed by one of the partners, and state that the partnership elects under IRC section 754 to apply IRC section 734(b) and IRC section 743(b). Once the election is made, it cannot be revoked without IRS consent. If the election cannot be made with the tax return, an extension of up to 12 months is available. See Regulation section 1.754-1(b) for more information about making an IRC section 754 election. [Reg. §1.754-1(b)]

**Request for IRC section 754 revocation.** Taxpayers may request revocation of a previous IRC section 754 election using Form 15254, *Request for Section 754 Revocation*.

**Author's Comment:** Since the election is revocable only with IRS consent and all future transactions must follow the rules of IRC section 754, care should be taken when making the election as it may be advantageous for the current situation, but it may not be desirable for future transactions.

**Mandatory basis adjustment.** The basis adjustment rules of IRC section 734 and IRC section 743 are mandatory in the case of the transfer of a partnership interest where there is a substantial built-in loss or a partnership distribution where there is a substantial basis reduction.

- A substantial built-in loss exists with respect to a transfer of an interest in a partnership if the partnership's adjusted basis in its property exceeds the FMV of the property by more than \$250,000.
- A substantial basis reduction exists if a downward basis adjustment of more than \$250,000 would be made to the basis of partnership assets if an optional basis adjustment election was in effect.
- A substantial built-in loss also exists if the transferee would be allocated a net loss in excess of \$250,000 upon a hypothetical disposition by the partnership of all partnership assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest. [IRC §743(d)]

**Example: IRC section 754 election in a distribution.** Andrea, Bud, and Charles each have a 33% ownership in ABC Partnership. ABC Partnership distributes equipment with a FMV of \$28,000 to Andrea. Andrea's outside basis in ABC Partnership is \$25,000. The \$3,000 difference (gain to be recognized by Andrea) is allocated to Bud and Charles and any related depreciation deductions are specifically allocated to Bud and Charles. No entry is made to record the \$3,000 IRC section 754 asset on the books of the partnership, and the \$3,000 is reflected in Bud and Charles's outside bases.

**Note:** In an IRC section 754 election, the step-up or step-down of the remaining assets is allocated to Bud and Charles. This equalizes the partners by providing Bud and Charles with a tax asset equal to the asset that the Andrea received.

**Example: IRC section 754 election in a transfer of an interest.** Don and Emily are 50/50 owners of DE Partnership. Don's previously taxed capital in the partnership is \$25,000. Don sells his interest to Dave for \$40,000. The \$15,000 difference is allocated to Dave and any related depreciation/amortization deductions are specifically allocated to Dave. No entry is made to record the \$15,000 IRC section 754 asset on the books of the partnership, and the \$15,000 is reflected in Dave's outside basis.

**Note:** When Dave acquired Don's interest in the partnership, the price was based on FMV. When assets in the partnership are greater in value than the outside basis, there is a distortion between Dave's outside basis and the proportionate value of the assets of the partnership. If an IRC section 754 election is made, the incoming partner receives a step-up or step-down for the difference between what is paid and the former partner's previously taxed capital. Any related depreciation/amortization deductions are specifically allocated to Dave.

# Partnership Distributions

## Cross References

- IRS Pub. 541, *Partnerships*
- IRC §731–737

## Related Topics

- Capital Gains and Losses (Schedule D), page 6-8
- Partnership Distributions—Disguised Sales, page 33-10

## Tax Effects of Distributions

A distribution to a partner will be either:

- A current distribution that does not completely retire the partner's interest in the partnership, or
- A liquidating distribution that does retire the partner's interest in the partnership.

A partnership does not recognize gain or loss on a distribution of money or property to a partner. [IRC §731(b)]

**New for 2024** **Form 7217, Partner's Report of Property Distributed by a Partnership.** Beginning with tax year 2024, Form 7217 is filed by any partner receiving a distribution of property from a partnership in a non-liquidating or a liquidating distribution to report the basis of the distributed property including any basis adjustment to such property. Form 7217 is not filed for:

- Distributions that consist only of money or marketable securities treated as money,
- Payments to the partner for services under IRC section 707 (guaranteed payments), and
- Transfers that are treated as disguised sales.

## Current Distributions

A current distribution is any distribution that does not completely retire a partner's interest in the partnership. A current distribution can either reduce the partner's capital account or can reduce the partner's ownership interest in the partnership.

**Gain.** Gain will not be recognized by a partner in a current distribution unless money is distributed. Gain is recognized only if the amount of money received exceeds the partner's adjusted basis in the partnership.

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**Example:** Sylvester and Adrienne are partners in a partnership. Each partner receives a current distribution of \$5,000 in cash. Sylvester's adjusted basis in his partnership interest is \$6,000. Adrienne's adjusted basis in her partnership interest is \$3,000. The \$5,000 distribution to Sylvester is not taxable, but does reduce his basis to \$1,000 (\$6,000 minus \$5,000 distribution = \$1,000 adjusted basis).

Adrienne has a capital gain of \$2,000 (\$5,000 distribution against \$3,000 basis).

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**Loss.** A loss will not be recognized by a partner on a current distribution.

**Basis of property received in a current distribution.** A partner's basis for property (other than money) received in a current distribution is the partnership's adjusted basis in the property. The property's basis is limited to the partner's adjusted basis in the partnership reduced by any money received in the same transaction. [IRC §732(a)]

**Partner's holding period.** A partner's holding period for property distributed to the partner includes the period the property was held by the partnership. If the property was contributed to the partnership by a partner, then the period it was held by that partner is also included.

## Liquidating Distributions

A liquidating distribution retires a partner's interest in the partnership. A series of payments made as part of a liquidation plan are all treated as liquidating distributions.

**Gain.** A partner will recognize gain on a liquidating distribution to the extent that money distributed exceeds the partner's adjusted basis in his or her partnership interest.

**Loss.** A loss on a liquidating distribution can be recognized if cash, unrealized receivables, or inventory items are received by the partner, and the total amount received is less than the partner's adjusted basis. If any other property is distributed to the partner, the partner cannot recognize a loss. The partner's entire interest in the partnership must be liquidated to recognize a loss on the distribution.

## Liabilities

Assumption of liabilities by a partner is treated as payment of money to the partnership. Assumption of liabilities results in an increase in the partner's basis.

Relief of liabilities is treated as money paid to the partner. The partner's basis is decreased by the amount of liabilities relieved.

## Sale of Partnership Interest

The sale or exchange of a partner's interest in a partnership generally results in capital gain or loss. For exceptions, see *Payments for Unrealized Receivables and Inventory Items*, page 20-18.

Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any liabilities, that partner must include the liability relief as part of the amount realized.

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**Example:** Fred became a partner in the Alphabet Partnership by contributing \$5,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of 2023 was \$20,000, which includes his \$15,000 share of partnership liabilities. The partnership has no unrealized receivables or inventory items. In 2024, Fred sold his interest in the partnership for \$10,000 in cash.

Fred realizes \$25,000 from the sale (\$10,000 cash payment plus \$15,000 liability relief). Fred reports \$5,000 capital gain on his Form 1040 (\$25,000 realized less \$20,000 basis).

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## Disguised Sale Rules

A transfer of property (other than money or an obligation to contribute money) by the partner to the partnership, and a transfer of money or other consideration by the partnership to the partner, is treated as a sale by the partner to the partnership if both of the following are true. [Reg. §1.707-3(b)]

- The transfer of money or other consideration would not have been made but for the transfer of property, and
- In cases where the transfers are not made simultaneously, the subsequent transfer is not dependent on the entrepreneurial risks of partnership operations.

**Facts and circumstances.** All facts and circumstances are considered in determining if the contribution and distribution are more properly characterized as a sale. However, if the contribution and distribution occur within two years of each other, the transfers are presumed to be a sale unless the facts clearly indicate that the transfers are not a sale. [Reg. §1.707-3(c)]

If the contribution and distribution occur more than two years apart, the transfers are presumed not to be a sale unless the facts clearly indicate that the transfers are a sale. A list of facts and circumstances which may indicate a disguised sale has taken place may be found in Regulation section 1.707-3(b)(2).



**Form 8275, Disclosure Statement.** A partner must attach Form 8275 to his or her return if the partner contributes property to a partnership and, within two years, the partnership transfers money or other consideration to the partner. A partnership must attach Form 8275 to its return if it distributes property to a partner, and, within two years, the partner transfers money or other consideration to the partnership.

### Certain Distributions Treated as Sales or Exchanges

When a partnership distributes the following items, the distributions may be treated as a sale or exchange of property rather than a distribution.

- Unrealized receivables or substantially appreciated inventory items distributed in exchange for any part of the partner's interest in other partnership property, including money.
- Other property (including money) distributed in exchange for any part of a partner's interest in unrealized receivables and/or substantially appreciated inventory items.
- Property distributed to satisfy guaranteed payments. Revenue Ruling 2007-40 provides that a partnership must recognize gain or loss as if the property had been sold at FMV and may treat the amount as a guaranteed payment (Rev. Rul. 2007-40). See *Guaranteed Payments*, page 20-9.

Sale or exchange treatment does not apply to distributions of property to the partner who contributed the property to the partnership, or payments made to a retiring partner or successor in interest of a deceased partner that are the partner's distributive share of partnership income or guaranteed payments.

**Substantially appreciated inventory items.** Inventory items are considered to have appreciated substantially in value if, at the time of the distribution, the total FMV is more than 120% of the partnership's adjusted basis for the property. However, if a principal purpose for acquiring inventory property is to avoid ordinary income treatment by reducing the appreciation to less than 120%, that property is excluded.

### Payments for Unrealized Receivables or Inventory

If a partner receives money or property in exchange for any part of a partnership interest, the amount due to his or her share of the partnership's unrealized receivables or inventory items results in ordinary income or loss. This amount is treated as if it were received for the sale or exchange of property that is not a capital asset.

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property. See *Liquidation at Partner's Retirement or Death*, next column.

**Unrealized receivables.** Unrealized receivables include any rights to payment not already included in income for the following items.

- Goods delivered, or to be delivered, to the extent the payment would be treated as received for property other than a capital asset.
- Services rendered or to be rendered.

**Other items treated as unrealized receivables.** Unrealized receivables include potential gain that would be ordinary income if certain partnership property was sold at its fair market value on the date of the payment. This includes items such as depreciation recapture under IRC sections 1245 or 1250, as well as several other items listed in IRS Pub. 541, *Partnerships*.

**Determining gain or loss.** The income or loss realized by a partner upon the sale or exchange of its interest in unrealized receivables and inventory items is the amount that would have been allocated to the partner if the partnership had sold all its

property for cash at FMV in a fully taxable transaction immediately prior to the partner's transfer of interest in the partnership.

### Form 8308, Report of a Sale or Exchange of Certain Partnership Interests

Form 8308 is filed by a partnership to report the sale or exchange by a partner of all or part of a partnership interest where any money or other property received in exchange for the interest is attributable to unrealized receivables or inventory items. Form 8308 is filed as an attachment to Form 1065 for the tax year of the partnership that includes the last day of the calendar year in which the exchange took place. The purpose of Form 8308 is to alert transferring partners that a portion of the gain from the exchange is treated as ordinary income.

### Distribution of Unrealized Receivables or Inventory

If a partner receives a distribution of unrealized receivables or inventory, gain or loss on subsequent sale by the partner is ordinary gain or loss.

**Exception:** If the partner sells inventory items held for more than five years after the distribution, the type of gain or loss depends on how the items are being used on the date of sale. The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold. [Reg. §1.735-1(a)(2)]

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**Example:** Sandra receives, through dissolution of her partnership, inventory that has a basis of \$19,000. Within five years, she sells the inventory for \$24,000. The \$5,000 gain is taxed as ordinary income. If Sandra had held the inventory for more than five years, her gain would have been capital gain, provided the inventory was a capital asset in her hands at the time of sale.

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**Inventory items.** Inventory items are not just stock in trade of the partnership. They also include the following.

- Any properties that would be included in inventory if on hand at the end of the tax year or that are held primarily for sale to customers in the normal course of business,
- Any asset that is not a capital asset or is not treated as a capital asset,
- Any other property held by the partnership that would be considered inventory if held by the transferor partner, or
- Any trade receivables of accrual method partnerships.

### Liquidation at Partner's Retirement or Death

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be allocated between payments in liquidation of the partner's interest in partnership property and other payments. The partnership's payments include an assumption of the partner's share of partnership liabilities treated as a distribution of money.

For income tax purposes, a retiring partner or successor in interest of a deceased partner is treated as a partner until his or her interest in the partnership has been completely liquidated.

**Liquidating payments.** Payments made in liquidation of the interest of a retiring or deceased partner in exchange for his or her interest in partnership property are considered a distribution, not a distributive share or guaranteed payment that could give rise to a deduction for the partnership.

**Unrealized receivables and goodwill.** Payments made for the retiring or deceased partner's share of the partnership's unrealized receivables or goodwill are not treated as made in exchange for partnership property if both of the following tests are met.

- Capital is not a material income-producing factor for the partnership. Capital is a material income-producing factor if a substantial part of the gross income of the business comes

from the use of capital (such as investments in inventory, plant, machinery, or equipment).

- The retiring or deceased partner was a general partner in the partnership.

However, this rule does not apply to payments for goodwill to the extent that the partnership agreement provides for a reasonable payment to a retiring partner for goodwill.

**Gain or loss on distribution.** Upon the receipt of the distribution, the retiring partner or successor in interest of a deceased partner will recognize gain only to the extent that any money distributed is more than the partner's adjusted basis in the partnership. The partner will recognize a loss only if the distribution is in money, unrealized receivables, and inventory items. No loss is recognized if any other property is received.

**Other payments.** Payments made by the partnership to a retiring partner or successor in interest of a deceased partner that are not made in exchange for an interest in a partnership property are treated as distributive shares of partnership income or guaranteed payments. This rule applies regardless of the time over which the payments are to be made. It applies to payments made for the partner's share of unrealized receivables and goodwill not treated as distributions.

- If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership.
- If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income. See *Guaranteed Payments*, page 20-9.
- These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.
- Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

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**Court Case:** The taxpayer, a lawyer, claimed payments received from his firm after retirement were capital gain rather than ordinary income. The Tax Court held that the payments made in place of a retirement plan for the firm's partners were guaranteed payments reportable as ordinary income. The payments were related to years worked for the firm and not in any way related to the size of the partner's interest or the profits of the law firm. (*Wallis*, T.C. Memo. 2009-243)

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## Partnership Interests Held in Connection With Performance of Investment Management Services

The tax treatment of certain gains attributable to a partnership interest created by contribution of investment management services depends on the holding period. Long-term capital gain or loss treatment applies to an applicable partnership interest held for longer than three years. Any net capital gain or loss that does not meet the three-year holding period is treated as a short-term capital gain.

**Applicable partnership interest.** An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to, or is held by, the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. The special recharacterization rule applies to:

- Capital gains recognized by a partner from the sale, exchange, or distribution of an applicable partnership interest, and
- Capital gains recognized by a partnership and allocated to a partner with respect to an applicable partnership interest.

**Applicable trade or business.** An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis which consists in whole or in part of raising or returning capital and either:

- Investing in or disposing of specified assets, or
- Developing specified assets.

**Specified assets.** Specified assets are:

- Securities as defined under rules for mark-to-market accounting for securities dealers [IRC §475(c)(2)],
- Commodities as defined under rules for mark-to-market accounting for commodities dealers [IRC §475(e)(2)],
- Real estate held for rental or investment,
- Options or derivative contracts with respect to such securities,
- Cash or cash equivalents, or
- An interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

## Terminating a Partnership

### Cross References

- IRS Pub. 541, *Partnerships*
- IRC §708, *Continuation of partnership*

### Related Topics

- *Accounting Periods*, page 8-26
- *Short Tax Year Depreciation*, page 9-6

### Tax Effects of Terminations

A partnership terminates when all the partnership operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership.

Upon the death of one partner in a two-member partnership, the partnership shall not be considered as terminated if the estate or other successor in interest of the deceased partner continues to share in the profits or losses of the partnership business. [Reg. §1.708-1(b)(1)(i)]

**Effect of termination by sale or exchange.** If a partnership is terminated by a sale or exchange of an interest, the partnership is deemed to have contributed all its assets and liabilities to a new partnership in exchange for an interest in the new partnership. Immediately thereafter, the terminated partnership is deemed to have distributed interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests in the terminated partnership in liquidation of the terminating partnership. [Reg. §1.708-1(b)(4)]

**Section 754 election.** If a partnership is terminated by sale or exchange of an interest in the partnership, a section 754 election that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. [Reg. §1.708-1(b)(5)] See *IRC Section 754 Election to Adjust Basis of Partnership Property*, page 20-16.

**Merger or consolidation.** If two or more partnerships merge or consolidate into one partnership, the resulting partnership shall be considered a continuation of the merging or consolidating partnership whose members own an interest of more than 50% in the capital and profits of the resulting partnership. [Reg. §1.708-1(c)]

If the resulting partnership can be considered a continuation of more than one of the merging or consolidating partnerships, it shall be considered the continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership. Any other merging or consolidating partnerships shall be considered as terminated.

If the members of none of the merging or consolidating partnerships have an interest of more than 50% in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.

**Division of a partnership.** Upon the division of a partnership into two or more partnerships, any resulting partnership or partnerships (other than any resulting partnership whose members had an interest of 50% or less in the capital and profits of the prior partnership) shall be considered a continuation of the prior partnership if the members of the resulting partnership or partnerships had an interest of more than 50% in the capital and profits of the prior partnership. Any other resulting partnership will not be considered a continuation of the prior partnership but will be considered a new partnership. [Reg. §1.708-1(d)]

If the members of none of the resulting partnerships owned an interest of more than 50% in the capital and profits of the prior partnership, none of the resulting partnerships will be considered a continuation of the prior partnership, and the prior partnership will be considered to have terminated.

Where members of a divided partnership do not become members of a resulting partnership which is considered a continuation of the prior partnership, such members' interests shall be considered liquidated as of the date of the division.

**Date of termination.** The partnership's tax year ends on the date the partnership completes the winding up of its affairs.

**Short year return.** If a partnership terminates before the end of the tax year, Form 1065 must be filed for the short tax year. The return is due the 15th day of the third month following the date of termination.

## Limited Liability Company (LLC)

### Cross References

- Form 8832, *Entity Classification Election*
- IRS Pub. 3402, *Taxation of Limited Liability Companies*

### Related Topics

- C Corporations, Tab 18
- S Corporations, Tab 19
- Business Entity Comparison Chart, page 27-3

### LLC Defined

An LLC is a business entity organized under state law. A multi-member LLC combines the tax aspects of a partnership with the liability protection of a corporation. Each state has its own regulations for entities organized within its jurisdiction.

**Ownership.** Owners of an LLC are called members. Most states do not restrict ownership. Members may include individuals, corporations, other LLCs, and foreign entities. There is no maximum number of members. Most states also permit LLCs having only one owner, referred to as single-member LLCs.

**Limited liability.** Unlike general partners, who may be held personally liable for claims against the partnership, all of the members of an LLC have limited personal liability for its debts. This affects members' at-risk basis and basis for gain or loss. In contrast to a general partner, an LLC member's basis in partnership debt does not increase unless that member personally guarantees the debt.

**Limited partners vs. LLC members.** Clear guidance is lacking as to whether LLC members should be treated as general partners or limited partners. General partners are defined in regulations by virtue of their liability for partnership debts. By definition, LLC members are not liable for partnership debts. This creates

uncertainty for issues such as self-employment tax on distributive share of income. See *General and Limited Partners*, page 20-6.

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**Court Case:** Roughly 99% of the net business income of a limited liability partnership was derived from legal services rendered by the attorney/partners. The IRS determined that the attorney/partners' distributive shares of the firm's income were net earnings from self-employment. The Tax Court agreed, stating that legislative history does not support excluding partners who perform services for a partnership from liability for self-employment taxes. (*Renkemeyer*, 136 T.C. No. 7)

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**Passive activity losses.** The Tax Court has ruled that the holder of an LLC or LLP interest is not treated as a limited partner for purposes of applying the material participation tests for passive activities when he or she has management rights in the entity. (*Garnett*, 132 T.C. No. 19)

Proposed regulations eliminate the current reliance on limited liability for determining whether an activity is passive under IRC section 469 and instead adopt an approach that relies on the individual partner/member's right to participate in the management of the entity. (REG-109369-10)

**Special situations.** Different rules may apply to special situations, including banks, insurance companies, or nonprofit organizations that are LLCs or own LLCs. Check the requirements for the state in which the business will be organized. There are special rules for foreign LLCs.

### LLC Classification

Depending on elections made by the LLC and the number of members, the IRS will treat an LLC as either a partnership, a disregarded entity, or as a corporation.

**Default classification.** An LLC with at least two members is classified as a partnership for federal income tax purposes. An LLC with only one member is treated as an entity disregarded as separate from its owner for income tax purposes, but as a separate entity for purposes of employment tax and certain excise taxes. See *Employment taxes and certain excise taxes*, page 20-21.

**Elected classification.** An LLC with either a single member or multiple members can elect to be taxed as a corporation for federal tax purposes. For information on making the election, see *Entity Classification Election*, page 18-17.

After an LLC has determined its federal tax classification, it can later elect to change that classification. See *Subsequent Elections (Changing Elections)*, page 20-22.

**Effective date of election.** Generally, an election specifying an LLC's classification cannot take effect more than 75 days prior to the date the election is filed, nor later than 12 months after the date the election is filed. Late election relief may be available in certain circumstances. See *Late election*, page 18-18.

### LLC Classified as Partnership

An LLC classified as a partnership is subject to the same filing and reporting requirements as a partnership.

**Member manager.** A member manager is any owner who, alone or together with others, has the continuing authority to make the management decisions necessary to conduct the business for which the LLC was formed. If there are no elected or designated member managers, each owner is treated as a member manager.

**Conversion of partnership into LLC.** The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest. The partnership's tax year does not close and the LLC can continue to use the partnership's taxpayer identification number. (Rev. Rul. 95-37)



The conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. (Rev. Rul. 84-52)

**Conversion of LLC into a partnership.** The above rules apply if an LLC classified as a partnership is converted into a partnership.

**Change in membership.** If the number of members in an LLC classified as a partnership is reduced to only one member, it becomes an entity disregarded as separate from its owner. [Reg. §301.7701-3(f)(2)]

**Corporation treatment elected prior to change in membership.** If the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classification as a disregarded entity will not apply.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

If a partnership that becomes a disregarded entity as a result of a decrease in the number of members makes an election to be classified as a corporation, the applicable deemed transactions will apply. See *Subsequent Elections (Changing Elections)*, page 20-22.

## LLC Classified as Disregarded Entity

If an LLC has only one member and does not elect to be treated as a corporation, it is classified as an entity disregarded as separate from its owner. Its income, deductions, gains, losses, and credits are reported on the owner's income tax return. For example, if the owner of the LLC is an individual, the LLC's income and expenses would be reported on the following schedules filed with the owner's Form 1040.

- Schedule C, *Profit or Loss From Business (Sole Proprietorship)*,
- Schedule E, *Supplemental Income and Loss*, or
- Schedule F, *Profit or Loss From Farming*.

A single-member LLC should not file a separate federal income tax return. However, a tax return or separate filing for a single-member LLC may be required for state tax purposes.

If the single-member LLC is owned by a corporation or partnership, the LLC should be reflected on its owner's federal tax return as a division of the corporation or partnership.

**Employment taxes and certain excise taxes.** Employment taxes (Forms 940, 941, etc.) must be reported and paid in the name and EIN of the LLC rather than in the name and EIN of the single-member owner. The single-member LLC is also required to use the LLC's name and EIN to register for certain excise taxes.

**Self-employment tax.** An individual owner of an LLC treated as a disregarded entity is not an employee of the LLC. The owner is subject to self-employment tax on the net earnings in the same manner as a sole proprietorship.

**Change in membership.** If a single-member LLC classified as a disregarded entity for income tax purposes acquires an additional member, it becomes a partnership. [Reg. §301.7701-3(f)(2)]

**Corporation treatment elected prior to change in membership.** If the LLC has made an election to be classified as a corporation and that election is in effect at the time of the change in membership, the default classification as a partnership will not apply.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

If a disregarded entity that becomes a partnership as a result of an increase in the number of members makes an election to be classified as a corporation, the applicable deemed transactions will apply. See *Subsequent Elections (Changing Elections)*, page 20-22.

## LLC Classified as Corporation

An LLC with either a single member or multiple members can elect for tax purposes to be classified as a corporation rather than as a partnership or disregarded entity. See *Entity Classification Election*, page 18-17. An LLC classified as a corporation is subject to the same tax filing and reporting requirements as a corporation. The entity may elect to be treated as an S corporation if it otherwise qualifies. An entity that timely elects to be treated as an S corporation by filing a valid Form 2553, *Election by a Small Business Corporation*, does not need to also file Form 8832, *Entity Classification Election*. See *Form 2553, Election by a Small Business Corporation*, Tab 19.

**Note:** If the LLC elects to be classified as a corporation by filing Form 8832, a copy of the form must be attached to the federal income tax return of each direct and indirect owner of the LLC for the tax year of the owner that includes that date on which the election took effect.

**C corporation.** If the entity is treated as a C corporation, it is taxed on its taxable income and distributions to members are includible in each member's gross income to the extent of the corporation's earnings and profits (double taxation).

**S corporation.** If the entity elects to be an S corporation, the corporation is generally not subject to an income tax. The income, deductions, gains, losses, and credits of the corporation pass through to the members.

**Conversion of S corporation to LLC.** A conversion from an S corporation to an LLC that elects to be taxed as a corporation can qualify as a tax-free reorganization under IRC section 368(a)(1)(F). In a letter ruling, the corporation did not recognize any gain or loss on the deemed exchange, and the basis and holding periods of the assets in the new LLC were the same as in the hands of the S corporation immediately before the exchange. The S corporation status did not terminate as a result of the reorganization because the new LLC retained its S corporation election and continued to meet S corporation requirements under IRC section 1361. (Ltr. Rul. 200528021)

**Change in membership.** If the LLC has made an election to be classified as a corporation and that elective classification is in effect at the time of the change in membership, the default classifications will not apply. The LLC continues to be treated as a corporation.

Other tax consequences of a change in membership, such as recognition of gain or loss, are determined by the transactions through which an interest in the LLC is acquired or disposed of.

## LLC Treated as Partnership vs. S Corporation

Comparison of LLC treated as a partnership to an S corporation.		
	LLC (Partnership)	S Corporation
Ownership	<ul style="list-style-type: none"> <li>• Unlimited number of members.</li> <li>• Non-U.S. citizens or residents allowed.</li> <li>• Can be owned by other corporations, partnerships, trusts, or LLCs.</li> </ul>	<ul style="list-style-type: none"> <li>• No more than 100 shareholders.</li> <li>• Shareholders must be U.S. citizens or residents.</li> <li>• Cannot be owned by other corporations, partnerships, trusts, or LLCs.</li> </ul>
Class of stock	Different membership classes allowed.	Only one class of stock allowed.

*continued on next page*

Comparison of LLC treated as a partnership to an S corporation continued		
	LLC (Partnership)	S Corporation
Transfer of ownership	Member approval often required.	Sale of stock allowed. IRS restrictions must be met to retain S status.
Formalities	Recommended: <ul style="list-style-type: none"> <li>• Adopt operating agreement.</li> <li>• Issue membership shares.</li> <li>• Hold and document annual member meetings.</li> </ul>	Required: <ul style="list-style-type: none"> <li>• Adopt bylaws.</li> <li>• Issue stock.</li> <li>• Annual director meetings.</li> <li>• Meeting minutes kept in corporate record book.</li> </ul>
Existence	Some states require dissolution date. Events such as death or withdrawal of member can cause LLC to dissolve.	Perpetual.
Income allocation	May decide to distribute income in any method agreed to by members.	Assigned to each shareholder strictly based on share of ownership.
Pass-through losses (subject to at-risk rules and passive activity loss limitations)	Tax basis rules may allow losses to be more easily passed to members. See <i>Partner's Basis In the Partnership (Outside Basis)</i> , page 20-13.	Pass-through losses limited to shareholder's basis in stock plus loans made by shareholder to corporation.
Self-employment taxes	Members subject to SE tax on guaranteed payments and possibly also distributive share of income. See <i>Limited partners vs. LLC members</i> , page 20-20.	Shareholder/employees subject to payroll taxes on wages but not subject to SE tax on distributive share of income.

For more information, see *Business Entity Attributes* chart, page 27-2.

## Subsequent Elections (Changing Elections)

Generally, once an LLC has elected to change its classification, it cannot elect again to change its classification during the 60 months after the effective date of the election. An election by a newly formed LLC that is effective on the date of formation is not considered a change for purposes of this limitation. [Reg. §301.7701-3(c)]

See also *Change in membership*, page 20-21.

**Partnership to corporation.** An election to change classification from a partnership to a corporation is treated as if the partnership contributed all of its assets and liabilities to the corporation in exchange for stock and the partnership then immediately liquidated by distributing the stock to its partners. See *Partnership Distributions*, page 20-17, and *Capital Contributions*, page 18-5.

**Corporation to partnership.** An election to change classification from a corporation to a partnership will be treated as if the corporation distributed all of its assets and liabilities to its shareholders in liquidation and the shareholders then immediately contributed all the distributed assets and liabilities to a new partnership. See *Contribution of property*, page 20-13, and *Distributions to Shareholders*, page 18-15.

**Corporation to disregarded entity.** An election to change classification from a corporation to a disregarded entity will be treated as if the corporation distributed all of its assets and liabilities to its single owner in liquidation. See *Distributions to Shareholders*, page 18-15.

**Disregarded entity to corporation.** An election to change classification from a disregarded entity to a corporation will be treated as if the owner of the disregarded entity contributed all of the assets and liabilities to the corporation in exchange for stock. See *Capital Contributions*, page 18-5.

## Conversion of single-member LLC to multiple-member LLC.

A single-member LLC is a disregarded entity (a sole proprietorship in the case of a single owner that is an individual) assuming it has not made the election to be taxed as a corporation. If the single-member LLC brings on a new member, the entity ceases to be a disregarded entity and a partnership is created for federal tax purposes. Treatment of the conversion depends on whether the new owner pays the old owner for a portion of his or her interest in the LLC or makes a payment to the LLC in exchange for an interest. (Rev. Rul. 99-5)

**New owner pays old owner for an interest in the LLC.** The new owner's purchase of the old owner's interest in the LLC is treated as the purchase of an interest in each of the LLC's assets. Immediately thereafter, both owners are treated as having contributed their respective interest in those assets to a partnership in exchange for ownership interests in the partnership. The old owner recognizes gain or loss from the deemed sale of the interest in the assets to the new owner.

**New owner makes a contribution to the LLC in exchange for an ownership interest.** The old owner is considered to have contributed all the assets to the partnership in exchange for a partnership interest. No gain or loss is recognized by either party as a result of the conversion. The new owner's interest in the partnership is equal to the amount contributed. The old owner's interest in the partnership is the adjusted basis of the assets considered to have been contributed to the new partnership.

## Conversion of multiple-member LLC to single-member LLC.

When a single taxpayer purchases all the ownership interests in an LLC that is taxed as a partnership for federal tax purposes, the LLC becomes a disregarded entity (a sole proprietorship in the case of an individual). Treatment of the conversion depends on whether the ownership interests are sold to a purchaser who is a member of the LLC, or the interests are sold to a purchaser who is an unrelated party. (Rev. Rul. 99-6)

**Owner sells entire interest in LLC to other owner.** The partnership terminates. The selling partner must treat the transaction as the sale of a partnership interest and must report gain or loss, if any, resulting from the sale of a partnership interest. For tax treatment of the purchasing partner, the partnership is deemed to have made a liquidating distribution of all its assets to the partners, and following the distribution, the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner.

**Outside party buys the LLC.** The partnership terminates. The selling partners must report gain or loss, if any, resulting from the sale of their partnership interests. The partnership is deemed to have made a liquidating distribution of its assets to the partners. Immediately following the distribution, the new owner is deemed to acquire, by purchase, all the former partnership's assets.

## Limited Liability Partnership (LLP)

Limited liability partnerships are entities formed under state law. The purpose of an LLP is generally to offer a degree of liability protection for professionals, such as doctors and lawyers, who wish to operate as partnerships. Typically, state LLP provisions will allow formation of a partnership but will shield a partner from liability for negligence or malpractice generated by another member of the partnership. Most states require some level of liability insurance to be maintained by LLPs.

For federal tax purposes, if the LLP does not make an election to be taxed as a corporation, the LLP is treated as a partnership, and as such, files Form 1065. An LLP is eligible to elect to be taxed as a corporation by filing Form 8832, *Entity Classification Election*. See *Entity Classification Election*, page 18-17.

## Publicly Traded Partnership (PTP)

### Cross References

- IRC § 7704, *Certain publicly traded partnerships treated as corporations*
- Notice 88-75

### Related Topics

- Passive Activity Losses, page 7-7
- Partners, LLC Members, Corporation Shareholders, page 7-10
- C Corporations, Tab 18

### Treatment of Publicly Traded Partnerships (PTP)

Certain publicly traded partnerships are treated as corporations. For purposes of this rule, a publicly traded partnership means any partnership if (1) interests in the partnership are traded on an established securities market, or (2) interests in the partnership are readily tradable on a secondary market (or a substantial equivalent). [IRC §7704(b)]

A PTP will not be treated as a corporation if at least 90% of its income is qualifying income. Qualifying income includes:

- Interest, dividends, real estate rental, and gains from the sale of real estate.
- Income and gains from certain operations for minerals or natural resources, industrial source carbon dioxide, or the transportation or storage of certain fuels. [IRC §7704(d)(1)(E)]
- Certain partnership income from the sale of commodities and futures.
- Gain from the sale of a capital asset held for the production of income.

**Effect of becoming a corporation.** As of the first day that a partnership is treated as a corporation, the partnership shall be treated as:

- Transferring all its assets (subject to its liabilities) to a newly formed corporation in exchange for the stock of the corporation, and
- Distributing such stock to its partners in liquidation of their interests in the partnership.

## Partnership Example

**Greener Pastures Partnership.** This example is part of a series that follows the business cycle of “Greener Pastures” from concept to inception, start-up to the end of the first tax year, then through completion of the tax return and reporting income to owners. The example illustrates how business transactions are reported for a partnership, and includes books, financial statements, and line-by-line illustrations of how to complete Form 1065, *U.S. Return of Partnership Income*.

Compare this example to the corresponding examples for C corporations in Tab 18 and S corporations in Tab 19.

**Principles of partnership taxation.** For federal tax purposes, a partnership is a pass-through entity. Partnership income and deductions are reported on Form 1065, then passed through to partners on Schedule K-1. Partners pay tax on income as it is earned, whether or not the income is distributed. Subsequent distributions of cash or property to partners are generally not taxable. See *Fundamentals of Partnership Taxation*, page 20-6, and *Partnership Distributions*, page 20-17.

### Scenario

Nate owned a lawn and garden implement store. Tyler owned a hydroseeding business. Nate and Tyler decided to go into business together under the name “Greener Pastures.”

**Creation of the partnership.** After consulting with an attorney for advice about the choice of business entity, Nate and Tyler decided to form a partnership. In their state, no special filings are required to form a partnership. The attorney assisted in drafting a partnership agreement. See *Partnership Agreement*, below.

- The attorney’s fee was \$2,000.

**Tax advice.** The tax consultant for Greener Pastures Partnership obtained an employer identification number (EIN) for the business. For information about obtaining an EIN, see page 5-1. The tax consultant then instructed the partners to open a business checking account and to make cash contributions to capital.

- The tax consultant’s fee was \$2,500.

**Business start date.** Greener Pastures Partnership opened for business on April 1, 2024.

### Partnership Agreement

Although a verbal agreement is all that is required to establish a partnership for federal tax purposes, a partnership should be formed under a written agreement. Tax treatment of certain items can be affected by the presence and content of a partnership agreement. For example, if a partner pays partnership expenses out-of-pocket, the partner cannot deduct those expenses against partnership income unless the partnership agreement requires payment of such expenses. Allowable unreimbursed expenses paid by a partner not only reduce income, but also reduce a partner’s income subject to self-employment tax. See *Unreimbursed Partnership Expenses*, page 20-12.

Also, any special allocations to partners must be made under the partnership agreement. If no allocations are made, all partners’ distributive shares of income and deductions are passed through based on each partner’s percentage of ownership interest. See *Distributive Share*, page 20-9.

**Capital contributions.** Nate makes an initial capital contribution in the amount of \$55,000. Tyler makes an initial capital contribution in the amount of \$45,000. The partners’ distributive shares of income and deductions will be allocated based on the ratio of capital contributions. Nate’s distributive share will be 55%. Tyler’s distributive share will be 45%.

**Employee benefits.** The partnership will pay health insurance premiums of \$3,900 for each partner and employee. It will also contribute to both HSA and SIMPLE plans for each partner and employee.

**Health savings accounts.** The partnership will contribute \$4,150 to an HSA for each individual. See *Line 19. Employee benefit programs*, page 20-27, for how to report on Form 1065. See *Health Savings Accounts (HSAs)* (IRC §223), page 22-6.

**SIMPLE plan.** The partnership will contribute to Savings Incentive Match Plans for Employees (SIMPLE plans) by means of establishing SIMPLE IRAs. The partnership will match employee elective deferrals dollar-for-dollar up to 3% of each employee’s wages.

**Note:** The SIMPLE payments made on behalf of the partners will be reflected on the partners’ Schedule K-1. Nate will make elective deferrals of \$5,500 and Tyler will make elective deferrals of \$4,500. For computation of employer’s matching contributions for partners, see *SIMPLE matching contributions*, page 20-28.

**Guaranteed payments.** Nate’s guaranteed payment base is \$55,755; Tyler’s guaranteed payment base is \$44,245. The partnership will also make payments for health insurance, contributions to HSAs, and SIMPLE matching payments on behalf of the partners.



**Note:** For purposes of this example, guaranteed payments will be reduced by the amount of SIMPLE elective contributions made on behalf of the partners so this example will more closely correspond to the C corporation and S corporation examples in Tab 18 and Tab 19. The SIMPLE contributions for partners' elective deferrals and matching amounts are reported as separately stated items on Form 1065 (Schedule K, line 13). Guaranteed payments of \$106,100 reported on the tax return break down as follows.

	Nate	Tyler
Base guaranteed payment .....	\$55,755	\$44,245
Health insurance .....	3,900	3,900
HSA contribution .....	4,150	4,150
SIMPLE elective deferrals .....	(5,500)	(4,500)
Total guaranteed payments .....	\$58,305	\$47,795

**Partners' unreimbursed partnership expenses.** The partners in Greener Pastures Partnership are responsible for paying their own professional publications, association dues, and sanctioning fees. The partners will deduct those expenses on pg. 2, Schedule E (Form 1040). Compare the same expenses paid by C corporation shareholders in Tab 18 and S corporation shareholders in Tab 19, which are not currently deductible and do not reduce employment taxes. See *Unreimbursed Partnership Expenses*, page 20-12.

In this example, Nate has incurred unreimbursed partnership expenses (UPE) of \$660 and Tyler has UPE of \$540.

**Tax year.** The partnership adopts a calendar tax year. The first tax year is a short tax year beginning on April 1 and ending on December 31. The partnership will establish its calendar tax year with the IRS when it files its first income tax return. For more information about a short tax year, see *Accounting Periods and Methods*, page 8-23, and *Short Tax Year Depreciation*, page 9-6.

**Accounting method.** The partnership will use the cash method of accounting.

**Inventory.** The partnership will hold inventory consisting of lawn and garden implements and hydroseeding materials. Under the general rule, if a company carries inventory, the accrual method of accounting must be used for purchases and sales. However, businesses with average gross receipts of \$30 million or less (2024) are eligible to use the cash method of accounting. Even though Greener Pastures Partnership will use the cash method of accounting, the cost of inventory will not be deducted until the products are sold. For more information about accounting for inventory, see *Inventory/Cost of Goods Sold*, page 8-13.

## Organizational Costs and Start-Up Costs

The attorney's fee of \$2,000 and the tax consultant's fee of \$2,500 are organizational costs. Travel expenses of \$1,660 were incurred visiting prospective suppliers in advance of the business start date of April 1, 2024. Because they were incurred before the business started operating, they are classified as start-up costs.

Organizational costs and start-up costs are capital expenses. An election is available to deduct up to \$5,000 in organization costs and \$5,000 in start-up costs for tax purposes. Amortization is available for amounts in excess of the limits. Greener Pastures Partnership will elect to deduct its organizational costs and start-up costs for tax year 2024. See *Start-Up Costs and Organizational Costs*, page 20-8.

## Purchase of Assets

Greener Pastures Partnership took out a bank loan of \$49,900 to purchase equipment for hydroseeding. It paid cash for display shelving, office furniture, and computers totaling \$19,500.

Equipment .....	\$49,900
Display shelving .....	10,000
Office furniture .....	5,000
Computers .....	4,500
Total .....	\$69,400

**Section 179 deduction and depreciation.** A Section 179 deduction of up to \$1,220,000 is available for tax year 2024. Greener Pastures Partnership elects to claim a Section 179 deduction for the display shelving only. The remaining assets will be depreciated for tax and book purposes under regular MACRS using a short tax year. The partnership elects out of the special depreciation allowance.

Note that the Section 179 deduction is not taken as an expense against taxable income on Form 1065. For a partnership, any amount claimed as a Section 179 deduction is passed through to the partners as a separately stated item on Schedule K-1. The partners in this example will deduct the Section 179 expense on pg. 2, Schedule E (Form 1040).

**Short tax year depreciation.** Since the partnership's first year is less than 12 months, depreciation cannot be computed using the MACRS percentage tables. See *Short Tax Year Depreciation*, page 9-6. See *2024 Tax Depreciation Schedule—Greener Pastures Partnership*, page 20-25.

## Payroll

**Employees.** Greener Pastures Partnership hired Evan to assist Tyler with hydroseeding, Cyndi as an assistant store manager, and Tristan and Jordan as salespeople. In addition to wages, the partnership will provide health benefits through health insurance and HSAs, and retirement benefits through a SIMPLE plan. See *Payroll Report for Year Ended December 31, 2024*, page 20-25.

## Distributions

In December 2024, Greener Pastures Partnership made cash distributions of \$5,500 to Nate and \$4,500 to Tyler.

## Financial Statements

The balance sheet and income statement for the short year ended December 31, 2024, along with the depreciation schedule and payroll report for Greener Pastures Partnership can be found on page 20-25. A cash flow reconciliation statement for the short year is found on page 20-26.

## Line-by-Line Explanations (Form 1065)

### Heading information:

**Item C.** Principal business activity codes, see page 25-6.

**Item D.** See page 5-1, for how to apply for an EIN.

**Item F.** Enter the partnership's total assets at the end of the tax year. If there are no assets at the end of the tax year, enter -0-. If the partnership is required to complete Schedule L, total assets from Schedule L, line 14, column (d) should match Form 1065 (page 1, item F).

## Income

**Line 1. Gross receipts or sales.** Enter gross receipts or sales from all trade or business operations except those entered on lines 4 through 7.

In this example, lawn and garden implement sales of \$265,500 and hydroseeding sales of \$278,300 add up to \$543,800 total sales.

**Line 2. Cost of goods sold (COGS).** The COGS is computed on Form 1125-A, *Cost of Goods Sold*, and carried to line 2.

In this example, COGS equals \$204,231 (rounded).

*continued on page 20-26*

## Payroll Report for Year Ended December 31, 2024

Employee	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	SIMPLE Elective Deferrals	Net Pay
Evan	\$31,200.00	\$1,934.40	\$ 452.40	\$2,493.00	\$1,635.00	\$ 3,120.00	\$21,565.20
Cyndi	\$27,300.00	\$1,692.60	\$ 395.85	\$2,007.00	\$1,369.00	\$ 2,730.00	\$19,105.55
Tristan	\$23,400.00	\$1,450.80	\$ 339.30	\$1,521.00	\$1,104.00	\$ 2,340.00	\$16,644.90
Jordan	\$23,400.00	\$1,450.80	\$ 339.30	\$1,521.00	\$1,104.00	\$ 2,340.00	\$16,644.90
Totals	\$105,300.00	\$6,528.60	\$1,526.85	\$7,542.00	\$5,212.00	\$10,530.00	\$73,960.55

### Final Pay Period—Taxes Deposited January 2025

	Gross Earnings	Social Security 6.20%	Medicare 1.45%	Federal Withholding	State Withholding	SIMPLE Elective Deferrals	Net Pay
	\$2,700.00	\$ 167.40	\$ 39.15	\$ 193.00	\$ 134.00	\$ 270.00	\$ 1,896.45

## 2024 Tax Depreciation Schedule—Greener Pastures Partnership

Asset	Placed in Service	Basis	Section 179	Depreciable Basis	Recovery Period	Method
Equipment	April 1, 2024	\$49,900.00	\$ 0.00	\$49,900.00	7 yr.	200DB
Display shelving	April 1, 2024	\$10,000.00	\$10,000.00	\$ 0.00	7 yr.	200DB
Office furniture	April 1, 2024	\$ 5,000.00	\$ 0.00	\$ 5,000.00	7 yr.	200DB
Computers	April 1, 2024	\$ 4,500.00	\$ 0.00	\$ 4,500.00	5 yr.	200DB
Totals		\$69,400.00	\$10,000.00	\$59,400.00		

### Regular Tax Depreciation—Short Tax Year 200DB

Equipment	$\$49,900 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$5,346$
Office furniture	$\$5,000 \times \frac{1}{7} \times 200\% \times \frac{4.5}{12} = \$ 536$
Computers	$\$4,500 \times \frac{1}{5} \times 200\% \times \frac{4.5}{12} = \$ 675$
Total regular tax depreciation	\$6,557

**Alternative minimum tax (AMT) adjustment.** For property placed in service after 2015 which qualifies for any special depreciation allowance, no AMT adjustment needs to be made for that class of property, even if the taxpayer elects out of such allowance. (Rev. Proc. 2017-33)

## Balance Sheet—Greener Pastures Partnership

December 31, 2024

### Assets:

Cash	\$102,244.00
Inventory	14,500.00
Equipment	49,900.00
Display shelving	10,000.00
Office furniture	5,000.00
Computers	4,500.00
Accumulated depreciation	(16,557.00)
Total assets	\$169,587.00

### Liabilities:

Payroll withholding payable	\$ 533.55
Employer's Social Security and Medicare payable	206.55
Sales tax payable	1,521.10
SIMPLE employee deferrals payable	270.00
SIMPLE partners' elective deferrals and match	13,828.72
Loan payable	43,943.66
Total liabilities	\$ 60,303.58

### Equity:

Capital contributions	\$100,000.00
Current earnings	19,283.42
Distributions	(10,000.00)
Total equity	\$109,283.42
Total liabilities plus equity	\$169,587.00

## Income Statement—Greener Pastures Partnership

Year ended December 31, 2024

### Revenue:

Lawn and garden implement sales	\$265,500.00
Hydroseeding services	278,300.00
Dividends earned	665.00
Gross income	\$544,465.00

### Cost of goods sold:

Beginning inventory	\$ 0.00
Purchases	218,730.77
Ending inventory	(14,500.00)
Cost of goods sold	\$204,230.77
Gross profit	\$340,234.23

### Expenses:

Accounting (organizational costs)	\$ 2,500.00
Advertising	3,000.00
Attorney fees (organizational costs)	2,000.00
Bookkeeping	2,800.00
Depreciation	16,557.00
Employee benefit programs	
HSA contributions	16,600.00
Health insurance	15,600.00
SIMPLE employer match	3,159.00
SIMPLE partners' elective deferrals	10,000.00
SIMPLE partners' employer match	3,828.72
Foreign tax paid	99.00
Guaranteed payments	106,100.00
Insurance—business	3,250.00
Interest expense	1,577.02
Meals and entertainment	1,100.00
Office expenses	2,325.00
Payroll taxes	9,845.07
Rent	10,800.00
Travel and lodging (start-up costs)	1,660.00
Utilities	2,850.00
Wages	105,300.00

Total expenses	\$320,950.81
Net income per books	\$ 19,283.42

# Cash Flow Reconciliation

**Business Name:** Greener Pastures Partnership **Period:** 4/1/24 to 12/31/24 **EIN:** 31-2345678

1) Starting cash balance ..... 1) 0.00

## Cash In

2) Customer receipts: categories

Lawn and garden implement sales	265,500.00
Hydroseeding services	278,300.00
Sales tax collected	18,253.13

Total customer receipts ..... 2) 562,053.13

3) Investment income: interest, dividends, etc.

Dividend income	665.00
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Total investment income ..... 3) 665.00

4) Cash received from accounts receivable not listed elsewhere ..... 4) \_\_\_\_\_

5) Cash received from sale of assets ..... 5) \_\_\_\_\_

6) Cash received from loan repayments ..... 6) \_\_\_\_\_

7) Cash received from loan proceeds ..... 7) 49,900.00

8) Contributions to capital ..... 8) 100,000.00

9) Other receipts ..... 9) \_\_\_\_\_

Total starting cash balance plus cash in ..... 712,618.13

## Cash Out

10) Business expenses: categories

Accounting (organization costs)	2,500.00
Advertising	3,000.00
Attorney fees (organization costs)	2,000.00
Bookkeeping	2,800.00
Employee benefit programs:	
HSA contributions	16,600.00
Health insurance	15,600.00
SIMPLE plan employer match	3,159.00
SIMPLE plan employee elective deferrals	10,260.00
Foreign tax paid	99.00
Guaranteed payments (includes \$8,300 HSA contributions & \$7,800 medical insurance for partners)	106,100.00
Insurance—business	3,250.00
Meals and entertainment	1,100.00
Office expenses	2,325.00
Payroll taxes:	
Federal unemployment (FUTA)	168.00
Federal quarterly (Form 941)	23,046.80
State unemployment	1,621.62
State withholding	5,078.00
Rent	10,800.00
Sales tax	16,732.03
Travel (start-up costs)	1,660.00
Utilities	2,850.00
Wages (net)	73,960.55

Total business expenses ..... 10) 304,710.00

11) Purchases of inventory ..... 11) 218,730.77

12) Loans payable

Asset			
Equipment			
Principal	5,956.34	Interest	1,577.02
= Total			7,533.36

Total loans payable ..... 12) 7,533.36

13) Paid on accounts payable ..... 13) \_\_\_\_\_

14) Cash disbursements on loans receivable ..... 14) \_\_\_\_\_

15) Cash distributions to owners ..... 15) 10,000.00

16) Cash paid for asset purchases ..... 16) 69,400.00

17) Other cash out ..... 17) \_\_\_\_\_

Total cash out for period ..... 610,374.13

Ending cash balance ..... 102,244.00

continued from page 20-24

## Deductions

**Line 9. Salaries and wages.** Enter salaries and wages paid to non-partners, reduced by certain employment-related credits.

Do not include salaries and wages reported elsewhere on Form 1065, such as guaranteed payments to partners, amounts included in COGS, or elective contributions made under a 401(k) plan, a SEP agreement, or a SIMPLE IRA plan.

In this example, gross employee wages of \$105,300 are reduced by elective SIMPLE contributions of \$10,530 for a total of \$94,770.

**Author's Comment:** Using the above method may result in a discrepancy between the amount listed on line 9 and what is re-reported for payroll tax purposes on Form 940, Form 941, Form W-2, and Form W-3. To the best of our knowledge, this does not create any matching issues with the IRS.

**Line 10. Guaranteed payments to partners.** Report payments to partners for services or for use of capital if the payments or credits are determined without regard to partnership income and are allocable to a trade or business. Also include amounts paid for medical insurance for a partner, partner's spouse, partner's dependents, or partner's children under age 27 who are not dependents.

In this example, guaranteed payments to partners total \$106,100. See *Guaranteed payments*, page 20-23, for a breakdown used in this example. Also see *Guaranteed Payments*, page 20-9, for more information.

**Line 13. Rent.** Enter rent paid on business property used in a trade or business activity.

In this example, the partnership paid \$10,800 during the year for facility rental.

**Line 14. Taxes and licenses.** Enter the taxes and licenses paid or incurred in the trade or business of the partnership.

In this example, taxes of \$9,845 (rounded) consists of employer Social Security tax of \$6,528.60, employer Medicare tax of \$1,526.85, FUTA of \$168.00, and state unemployment taxes of \$1,621.62.

**Line 15. Interest.** Include only interest incurred in the partnership's trade or business activities that is not claimed elsewhere on the return.

See *Business Interest Expense Limitation*, page 20-9.

In this example, \$1,577 interest was paid on the loan for the hydroseeding equipment.

**Line 16. Depreciation.** Enter only the depreciation claimed on assets used in a trade or business activity. Complete Form 4562 only if the partnership placed property in service during the tax year or claims depreciation on any car or other listed property.



Draft as of June 20, 2024

**Form 1065 U.S. Return of Partnership Income**

OMB No. 1545-0123

For calendar year 2024, or tax year beginning 4/1, 2024, ending 12/31, 2024

**2024**

Department of the Treasury Internal Revenue Service  
Go to [www.irs.gov/Form1065](http://www.irs.gov/Form1065) for instructions and the latest information.

<b>A</b> Principal business activity <b>Retail Sales</b>	Name of partnership <b>Greener Pastures Partnership</b>	<b>D</b> Employer identification number <b>31-2345678</b>
<b>B</b> Principal product or service <b>Lawn &amp; Garden Supplies</b>	Number, street, and room or suite no. If a P.O. box, see instructions. <b>123 Prairie Point</b>	<b>E</b> Date business started <b>4/1/24</b>
<b>C</b> Business code number <b>444200</b>	City or town, state or province, country, and ZIP or foreign postal code <b>Farmdale, MN 55555</b>	<b>F</b> Total assets (see instructions) <b>\$ 169,587</b>

**G** Check applicable boxes: (1)  Initial return (2)  Final return (3)  Name change (4)  Address change (5)  Amended return

**H** Check accounting method: (1)  Cash (2)  Accrual (3)  Other (specify):

**I** Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year: **2**

**J** Check if Schedules C and M-3 are attached

**K** Check if partnership: (1)  Aggregated activities for section 465 at-risk purposes (2)  Grouped activities for section 469 passive activity purposes

**Caution:** Include only trade or business income and expenses on lines 1a through 23 below. See instructions for more information.

<b>Income</b>	<b>1a</b> Gross receipts or sales <b>543,800</b>	<b>b</b> Less returns and allowances	<b>c</b> Balance	<b>1c</b> <b>543,800</b>
	<b>2</b> Cost of goods sold (attach Form 1125-A)		<b>2</b> <b>204,231</b>	
	<b>3</b> Gross profit. Subtract line 2 from line 1c		<b>3</b> <b>339,569</b>	
	<b>4</b> Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)		<b>4</b>	
	<b>5</b> Net farm profit (loss) (attach Schedule F (Form 1040))		<b>5</b>	
	<b>6</b> Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)		<b>6</b>	
	<b>7</b> Other income (loss) (attach statement)		<b>7</b>	
	<b>8</b> <b>Total income (loss).</b> Combine lines 3 through 7		<b>8</b> <b>339,569</b>	
<b>Deductions</b> (see instructions for limitations)	<b>9</b> Salaries and wages (other than to partners) (less employment credits)	<b>9</b> <b>94,770</b>		
	<b>10</b> Guaranteed payments to partners	<b>10</b> <b>106,100</b>		
	<b>11</b> Repairs and maintenance	<b>11</b>		
	<b>12</b> Bad debts	<b>12</b>		
	<b>13</b> Rent	<b>13</b> <b>10,800</b>		
	<b>14</b> Taxes and licenses	<b>14</b> <b>9,845</b>		
	<b>15</b> Interest (see instructions)	<b>15</b> <b>1,577</b>		
	<b>16a</b> Depreciation (if required, attach Form 4562)	<b>16a</b> <b>6,557</b>		
	<b>b</b> Less depreciation reported on Form 1125-A and elsewhere on return	<b>16b</b>	<b>16c</b> <b>6,557</b>	
	<b>17</b> Depletion (Do not deduct oil and gas depletion.)	<b>17</b>		
<b>Tax and Payment</b>	<b>18</b> Retirement plans, etc.	<b>18</b> <b>13,689</b>		
	<b>19</b> Employee benefit programs	<b>19</b> <b>32,200</b>		
	<b>20</b> Energy efficient commercial buildings deduction (attach Form 7205)	<b>20</b>		
	<b>21</b> Other deductions (attach statement)	<b>21</b> <b>20,735</b>		
	<b>22</b> <b>Total deductions.</b> Add the amounts shown in the far right column for lines 9 through 21	<b>22</b> <b>296,273</b>		
	<b>23</b> <b>Ordinary business income (loss).</b> Subtract line 22 from line 8	<b>23</b> <b>43,296</b>		
	<b>24</b> Interest due under the look-back method—completed long-term contracts (attach Form 8697)	<b>24</b>		
	<b>25</b> Interest due under the look-back method—income forecast method (attach Form 8866)	<b>25</b>		
	<b>26</b> BBA AAR imputed underpayment (see instructions)	<b>26</b>		
	<b>27</b> Other taxes (see instructions)	<b>27</b>		
<b>28</b> <b>Total balance due.</b> Add lines 24 through 27	<b>28</b> <b>0</b>			
<b>29</b> Elective payment election amount from Form 3800	<b>29</b>			
<b>30</b> Payment (see instructions)	<b>30</b>			
<b>31</b> <b>Amount owed.</b> If the sum of line 29 and line 30 is smaller than line 28, enter amount owed	<b>31</b> <b>0</b>			
<b>32</b> <b>Overpayment.</b> If the sum of line 29 and line 30 is larger than line 28, enter overpayment	<b>32</b>			

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than partner or limited liability company member) is based on all information of which preparer has any knowledge.

**Sign Here**  
Signature of partner or limited liability company member \_\_\_\_\_ Date \_\_\_\_\_

May the IRS discuss this return with the preparer shown below? See instructions.  Yes  No

<b>Paid Preparer Use Only</b>	Print/Type preparer's name	Preparer's signature	Date	Check <input type="checkbox"/> if self-employed	PTIN
	Firm's name	Firm's EIN	Phone no.		

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incurred during 2024. The entertainment expense is not deductible.

Following is a statement of other deductions for this example.



**Statement of Other Deductions—  
Line 21, Form 1065**

Accounting (organization costs).....	\$2,500
Advertising .....	3,000
Attorney fees (organization costs).....	2,000
Bookkeeping .....	2,800
Insurance-business .....	3,250
Meals (\$700 × 50%).....	350
Office expenses .....	2,325
Travel and lodging (start-up costs) .....	1,660
Utilities .....	2,850
<b>Total other deductions .....</b>	<b>\$20,735</b>

**Schedules K and K-1 (Form 1065)**

**Schedule K.** Schedule K is a summary schedule of all partners' shares of the partnership's income, credits, deductions, etc. Since rental activity income or loss and portfolio income are not reported on pg. 1, Form 1065, Schedule K is used to report these and other amounts.

In this example, the following items are reported Schedule K.

- Line 1, Ordinary business income, \$43,296.
- Line 4a, Guaranteed payments: services, \$106,100.
- Line 4c, Guaranteed payments: total, \$106,100.
- Line 6a, Ordinary dividends, \$665.
- Line 6b, Qualified dividends, \$665.
- Line 12, Section 179 deduction, \$10,000.
- Line 13e, Other deductions, includes partners' HSA contributions of \$8,300, partners' health insurance of \$7,800, partners' SIMPLE elective deferrals of \$10,000, and partners' SIMPLE matching contributions of \$3,829, for a total of \$29,929. See *SIMPLE matching contributions*, page 20-28.
- Line 14a, Net earnings from self-employment includes \$43,296 ordinary income plus \$106,100 guaranteed payments for a total of \$149,396.
- Line 14c, Gross nonfarm income, \$339,569.
- Line 16, International. The box on line 16 is not checked because the partnership meets the domestic filing exception for preparing and furnishing Schedules K-2 and K-3. A statement is attached to Form 1065 that states "Qualified for exception to filing Schedule K-2." A statement is also attached to Schedule K-1 notifying the partners that they will not receive a Schedule K-3 from the partnership unless the partner requests the schedule. Neither partner requested the schedule. See *Domestic filing exception*, page 20-11.
- Line 18c, Nondeductible expenses, \$750. Nondeductible expenses consist of nondeductible meals and entertainment.
- Line 19a, Cash distributions of \$10,000.
- Line 20a, Investment income, \$665.

Do not include any Section 179 expense on this line. Section 179 expense is not deducted by the partnership and is a separately stated item passed through to partners in box 12, Schedule K-1.

In this example, the depreciation deducted by the partnership after considering the Section 179 expense was \$6,557. A Section 179 deduction in the amount of \$10,000 was allocated and passed through to partners on Schedule K-1. See *2024 Tax Depreciation Schedule—Greener Pastures*, page 20-25.

**Line 18. Retirement plans, etc.** Do not deduct payments for partners to retirement or deferred compensation plans. These amounts are instead reported in box 13, Schedule K-1, using Code R, and are deducted by the partners on their own returns.

Enter the deductible contribution not claimed elsewhere on the return made by the partnership for its common-law employees.

In this example, \$13,689 consists of SIMPLE plan employee elective deferrals of

\$10,530 and employer matching contributions of \$3,159.

**Line 19. Employee benefit programs.** Do not include amounts paid during the tax year for medical insurance for a partner, partner's spouse, or partner's dependents. Include such payments as guaranteed payments and report on Schedule K-1.

In this example, the employee benefit programs deduction of \$32,200 includes \$15,600 paid for health insurance for the employees, and \$16,600 in contributions made to the employees' HSAs.

**Line 21. Other deductions.** Enter the total allowable trade or business deductions not listed on other lines on Form 1065. Attach a statement listing the type and amount.

**Meals and entertainment.** Meals and entertainment expense of \$1,100 represents \$700 of meals and \$400 of entertainment. The meals were meetings with the partners and potential clients. The partnership can deduct 50% of business meals paid or

- Line 21, Foreign taxes paid or accrued, \$99.

**Schedule K-1.** Schedule K-1 shows each partner's separate share of items from Schedule K. Attach a copy of each Schedule K-1 to Form 1065 filed with the IRS. Also provide the appropriate copy of Schedule K-1 to each partner. See *Schedule K-1 Codes (Form 1065)—Partnership*, page 20-3.

In this example, the following items are reported to Nate on Schedule K-1 for reporting on his individual income tax return.

- Line 1, Share of ordinary business income, \$23,313.
- Line 4a, Guaranteed payments for services, \$58,305. See *Guaranteed payments*, page 20-23.
- Line 4c, Total guaranteed payments, \$58,305.
- Line 6a, Share of ordinary dividends, \$366.
- Line 6b, Share of qualified dividends, \$366.
- Line 12, Share of Section 179 deduction, \$5,500.
- Line 13, code M, Health insurance of \$3,900.
- Line 13, code R, SIMPLE elective deferrals of \$5,500 and SIMPLE matching contributions of \$2,105 for a total of \$7,005. See *SIMPLE matching contributions*, below.
- Line 13, code W, HSA contribution of \$4,150.
- Line 14, code A, Self-employment earnings includes \$23,813 ordinary income plus \$58,305 guaranteed payments for a total of \$82,118.
- Line 14, code C, Share of gross nonfarm income, \$186,763.
- Line 18, code C, Share of nondeductible expenses, \$413.
- Line 19, code A, Distributions of \$5,500.
- Line 20, code A, Share of investment income, \$366.
- Line 20, code N, Share of business interest expense, \$867.
- Line 20, code Z. The IRC section 199A (QBI) deduction is determined at the partner level where the partner is an individual, trust, or estate. Use code Z with an asterisk (Z\*) and enter "STMT" to indicate that the information is provided on an attached statement separately identifying the partner's distributive share of:
  - Qualified items of income, gain, deduction, and loss,
  - W-2 wages,
  - Unadjusted basis immediately after acquisition (UBIA) of qualified property,
  - Qualified publicly traded partnership (PTP) items, and
  - IRC section 199A dividends, also known as qualified real estate investment trust (REIT) dividends.

The partnership must make an initial determination of which items are qualified items of income, gain, deduction, and

Form 1065 (2024)		Draft as of June 20, 2024		Page 5
Schedule K Partners' Distributive Share Items				Total amount
Income (Loss)	1	Ordinary business income (loss) (page 1, line 23)		43,296
	2	Net rental real estate income (loss) (attach Form 8825)		
	3a	Other gross rental income (loss)	3a	
	b	Expenses from other rental activities (attach statement)	3b	
	c	Other net rental income (loss). Subtract line 3b from line 3a		
	4	Guaranteed payments: a Services 4a 106,100 b Capital 4b		106,100
	c	Total. Add lines 4a and 4b	4c	
	5	Interest income	5	
	6	Dividends and dividend equivalents: a Ordinary dividends	6a	665
	b	Qualified dividends 6b 665 c Dividend equivalents 6c		
	7	Royalties	7	
8	Net short-term capital gain (loss) (attach Schedule D (Form 1065))	8		
9a	Net long-term capital gain (loss) (attach Schedule D (Form 1065))	9a		
b	Collectibles (28%) gain (loss)	9b		
c	Unrecaptured section 1250 gain (attach statement)	9c		
10	Net section 1231 gain (loss) (attach Form 4797)	10		
11	Other income (loss) (see instructions) Type:	11		
Deductions	12	Section 179 deduction (attach Form 4562)	12	10,000
	13a	Cash contributions	13a	
	b	Noncash contributions	13b	
	c	Investment interest expense	13c	
	d	Section 59(e)(2) expenditures: (1) Type: (2) Amount:	13d(2)	29,929
Self-Employment	14a	Net earnings (loss) from self-employment	14a	149,396
	b	Gross farming or fishing income	14b	
	c	Gross nonfarm income	14c	339,569
Credits	15a	Low-income housing credit (section 42(i)(5))	15a	
	b	Low-income housing credit (other)	15b	
	c	Qualified rehabilitation expenditures (rental real estate) (attach Form 3468, if applicable)	15c	
	d	Other rental real estate credits (see instructions) Type:	15d	
	e	Other rental credits (see instructions) Type:	15e	
	f	Other credits (see instructions) Type:	15f	
Inter-national	16	Attach Schedule K-2 (Form 1065), Partners' Distributive Share Items—International, and check this box to indicate that you are reporting items of international tax relevance <input type="checkbox"/>		
Alternative Minimum Tax (AMT) items	17a	Post-1986 depreciation adjustment	17a	
	b	Adjusted gain or loss	17b	
	c	Depletion (other than oil and gas)	17c	
	d	Oil, gas, and geothermal properties—gross income	17d	
	e	Oil, gas, and geothermal properties—deductions	17e	
	f	Other AMT items (attach statement)	17f	
Other Information	18a	Tax-exempt interest income	18a	
	b	Other tax-exempt income	18b	
	c	Nondeductible expenses	18c	750
	19a	Distributions of cash and marketable securities	19a	10,000
	b	Distributions of other property	19b	
	20a	Investment income	20a	665
	b	Investment expenses	20b	
c	Other items and amounts (attach statement)			
21	Total foreign taxes paid or accrued	21	99	

loss at its level and report to each partner its distributive share of all items that may be qualified items at the partner level. The partner must then determine whether each item is includible in QBI.

Use *Statement A—QBI Pass-Through Entity Reporting*, from the Form 1065 instructions, or a similar statement to provide this information to each partner.

Additionally, the partnership must report whether any of its trades or businesses are specified service trades or businesses (SSTBs) and identify on the statement any trades or businesses that are aggregated.

- Line 21, Share of foreign taxes paid or accrued, \$54.

**SIMPLE matching contributions.** For SIMPLE plans, net earnings from self-employment is the amount on line 4, Part 1, Schedule SE (Form 1040), *Self-Employment Tax*.

The matching contributions in this example are computed as follows.

	Nate	Tyler
K-1 line 1. Ordinary income.	\$23,813	\$19,483
K-1 line 4. Guaranteed payments.	58,305	47,795

continued in next column

continued	Nate	Tyler
K-1 line 12. Section 179 expense.	(5,500)	(4,500)
Partner's unreimbursed expenses.	(660)	(540)
<b>Total income from self-employment</b>	<b>75,958</b>	<b>62,238</b>
× 92.35%	70,147	57,477
<b>3% match</b>	<b>\$2,105</b>	<b>\$1,724</b>

**Author's Comment:** IRS Pub. 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans)*, states that for purposes of computing SIMPLE plan limits for partners, net earnings from self-employment is the amount from line 4, Part 1 of the partner's Schedule SE (Form 1040). This amount will often not be correct, for example when there is additional income from other sources of self-employment, such as a different sole proprietorship operated by the individual.

For purposes of this example, the matching contribution was based on self-employment income passing through on Schedule K-1, reduced by the Section 179 deduction and the deduction for unreimbursed partnership expenses. Before the partnership can properly calculate the employer SIMPLE matching contribution, the partner must inform it of any unreimbursed partnership expenses they plan to deduct on their personal return.

Form 1065 (2024)		Draft as of June 20, 2024				Page 6		
<b>Analysis of Net Income (Loss) per Return</b>								
1	Net income (loss). Combine Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13e, and 21					1	110,033	
2	Analysis by partner type:		(i) Corporate	(ii) Individual (active)	(iii) Individual (passive)	(iv) Partnership	(v) Exempt organization	(vi) Nominee/Other
a	General partners			110,033				
b	Limited partners							
<b>Schedule L Balance Sheets per Books</b>								
			Beginning of tax year		End of tax year			
			(a)	(b)	(c)	(d)		
<b>Assets</b>								
1	Cash					102,244		
2a	Trade notes and accounts receivable							
b	Less allowance for bad debts							
3	Inventories					14,500		
4	U.S. Government obligations							
5	Tax-exempt securities							
6	Other current assets (attach statement)							
7a	Loans to partners (or persons related to partners)							
b	Mortgage and real estate loans							
8	Other investments (attach statement)							
9a	Buildings and other depreciable assets				69,400			
b	Less accumulated depreciation				16,557	52,843		
10a	Depletable assets							
b	Less accumulated depletion							
11	Land (net of any amortization)							
12a	Intangible assets (amortizable only)							
b	Less accumulated amortization							
13	Other assets (attach statement)							
14	Total assets					169,587		
<b>Liabilities and Capital</b>								
15	Accounts payable							
16	Mortgages, notes, bonds payable in less than 1 year							
17	Other current liabilities (attach statement)					16,360		
18	All nonrecourse loans							
19a	Loans from partners (or persons related to partners)							
b	Mortgages, notes, bonds payable in 1 year or more					43,944		
20	Other liabilities (attach statement)							
21	Partners' capital accounts					109,283		
22	Total liabilities and capital					169,587		
<b>Schedule M-1 Reconciliation of Income (Loss) per Books With Analysis of Net Income (Loss) per Return</b>								
Note: The partnership may be required to file Schedule M-3. See instructions.								
1	Net income (loss) per books		19,283	6	Income recorded on books this year not included on Schedule K, lines 1 through 11 (itemize):			
2	Income included on Schedule K, lines 1, 2, 3c, 5, 6a, 7, 8, 9a, 10, and 11, not recorded on books this year (itemize):			a	Tax-exempt interest \$			
3	Guaranteed payments (other than health insurance)		90,000	7	Deductions included on Schedule K, lines 1 through 13e, and 21, not charged against book income this year (itemize):			
4	Expenses recorded on books this year not included on Schedule K, lines 1 through 13e, and 21 (itemize):			a	Depreciation \$			
a	Depreciation \$			8	Add lines 6 and 7			
b	Travel and entertainment \$		750	9	Income (loss) (Analysis of Net Income (Loss) per Return, line 1). Subtract line 8 from line 5			
5	Add lines 1 through 4		110,033					
					110,033			
<b>Schedule M-2 Analysis of Partners' Capital Accounts</b>								
1	Balance at beginning of year		0	6	Distributions: a Cash			
2	Capital contributed: a Cash		100,000	b	Property			
	b Property			7	Other decreases (itemize): M&E 750;			
3	Net income (loss) (see instructions)		110,033		Guaranteed payments 90,000			
4	Other increases (itemize):			8	Add lines 6 and 7			
5	Add lines 1 through 4		210,033	9	Balance at end of year. Subtract line 8 from line 5			
					109,283			

**Self-employment for LLC members.** Had this partnership been taxed as an LLC, a problem arises in determining the SE income of the LLC member for purposes of calculating the employer match for a SIMPLE plan. If the LLC takes the stand that income from line 1, Schedule K-1, is not self-employment income, then the applicable amount for computing the employer match will consist only of guaranteed payments.

For reporting items on Schedule K-1, see *Separately Stated Partnership Items*, page 20-10, and *Schedule K-1 Codes (Form 1065)—Partnership*, page 20-3.

### Schedule L—Balance Sheets per Books

Schedules L, M-1, and M-2 are not required to be completed if the partnership answered "Yes" to question 4, Schedule B (total receipts less than \$250,000, assets less

than \$1 million, Schedules K-1 filed and furnished to partners, and partnership not filing nor required to file Schedule M-3).

The balance sheets should agree with the partnership's books and records. Attach a statement explaining any differences.

**Author's Comment:** A partnership that is not required to complete Schedules L, M-1, and M-2 must still maintain adequate books and records for income tax purposes. Completing Schedules L, M-1, and M-2, even when not required, may be beneficial in assuring that the tax return has been prepared properly based on book income.

**Line 14. Total assets.** Total assets must be determined without offset by liabilities and may not be reported as a negative amount. Generally, total assets at the beginning of the tax year must equal total assets at the close of the prior year. If the

amounts do not match, attach a statement explaining the difference.

### Schedule M-1—Reconciliation of Income (Loss) per Books With Analysis of Net Income (Loss) per Return

Items such as limitations on the deduction for meals and entertainment, separately stated items, and guaranteed payments cause differences between book income and income on the tax return. The amounts are reconciled on Schedule M-1.

For more information, see *Schedule M-1, Reconciliation of Income (Loss) per Books With Income (Loss) per Return*, page 27-16.

**Line 1, Net income (loss) per books.** In this example, partnership net income is \$19,283. See *Income Statement—Greener Pastures Partnership*, page 20-25.

**Line 3, Guaranteed payments.** Include on this line guaranteed payments other than amounts paid for partners' health insurance.

In this example, guaranteed payments of \$106,100 are reduced by \$7,800 partners' health insurance payments as well as \$8,300 partners' HSA contributions for a total of \$90,000. See *Guaranteed payments*, page 20-23.

**Line 4, Expenses recorded on books not included on Schedule K.** In this example, include \$750 nondeductible meals and entertainment expenses.

### Schedule M-2—Analysis of Partners' Capital Accounts

Schedule M-2 reflects changes to partners' capital accounts that occurred during the year as shown on the partnership's books. The amounts on Schedule M-2 should equal the total of the amounts reported in item L of all the partners' Schedules K-1.

**Line 2. Capital contributed during year.** Include on line 2a the amount of money contributed, and on line 2b the amount of property contributed by each partner to the partnership as reflected on the partnership's books and records.

In this example, the partners contributed cash of \$100,000. See *Capital contributions*, page 20-23.

#### Line 6. Distributions.

**Line 6a. Cash.** Enter the amount of money or FMV of marketable securities distributed to each partner by the partnership. Marketable securities include financial instruments and foreign currencies which are actively traded.

In this example, the partnership distributed \$10,000 to the partners. See *Distributions*, page 20-24.



651123  
OMB No. 1545-0123

**Schedule K-1 (Form 1065) 2024**  
Department of the Treasury Internal Revenue Service  
For calendar year 2024, or tax year beginning 4/1/2024 ending 12/31/2024

**Partner's Share of Income, Deductions, Credits, etc.**  
See separate instructions.

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items	
1 Ordinary business income (loss) <b>23,813</b>	14 Self-employment earnings (loss) <b>A 82,118</b>
2 Net rental real estate income (loss)	C <b>186,763</b>
3 Other net rental income (loss)	15 Credits
4a Guaranteed payments for services <b>58,305</b>	16 Schedule K-3 is attached if checked <input type="checkbox"/>
4b Guaranteed payments for capital	17 Alternative minimum tax (AMT) items
4c Total guaranteed payments <b>58,305</b>	
5 Interest income	
6a Ordinary dividends <b>366</b>	
6b Qualified dividends <b>366</b>	18 Tax-exempt income and nondeductible expenses <b>C 413</b>
6c Dividend equivalents	
7 Royalties	
8 Net short-term capital gain (loss)	19 Distributions
9a Net long-term capital gain (loss) <b>A 5,500</b>	
9b Collectibles (28%) gain (loss)	20 Other information
9c Unrecaptured section 1250 gain	<b>A 366</b>
10 Net section 1231 gain (loss) <b>N 867</b>	<b>Z* STMT</b>
11 Other income (loss)	
12 Section 179 deduction <b>5,500</b>	21 Foreign taxes paid or accrued <b>54</b>
13 Other deductions <b>M 3,900</b>	
<b>R 7,605</b>	
<b>W 4,150</b>	
22 <input type="checkbox"/> More than one activity for at-risk purposes*	
23 <input type="checkbox"/> More than one activity for passive activity purposes*	

\*See attached statement for additional information.

Partner's Capital Account Analysis	
Beginning capital account	<b>0</b>
Capital contributed during the year	<b>55,000</b>
Current year net income (loss)	<b>61,275<sup>1</sup></b>
Other increase (decrease) (attach explanation)	<b>(50,668)<sup>2</sup></b>
Withdrawals and distributions	<b>5,500</b>
Ending capital account	<b>60,107</b>

M Did the partner contribute property with a built-in gain (loss)?  
 Yes  No If "Yes," attach statement. See instructions.

Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)	
Beginning	<b>(413)</b>
Ending	<b>(50,668)</b>

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2024

**Greener Pastures Partnership Schedule K-1 Supplemental Information**

**Line 16, International**  
Due to the domestic filing exception, the partnership is not required to file Schedules K-2 or K-3 this year. The partner will not be receiving a Schedule K-3 unless requested.

**Line 20, Code N, Business Interest Expense**  
Deductible business interest expense for inclusion in the separate loss class for computing any basis limitation [defined in IRC section 704(d) and Regulations section 1.163(j)-6(h)].  
Included on Schedule K-1, line 1 ..... \$867

**Line 20, Code Z, Section 199A Information**

Income Items	Non-SSTB	SSTB
Ordinary items.....	23,813	0
<b>Deduction Items</b>		
Section 179 expense deduction.....	5,500	0
<b>Additional Information</b>		
Section 199A W-2 wages.....	57,915 <sup>1</sup>	0
Section 199A unadjusted basis.....	38,170 <sup>2</sup>	0

<sup>1</sup> W-2 wages = 105,300 × 55%    <sup>2</sup> Unadjusted basis = 69,400 × 55%

Draft as of July 8, 2024

**Form 1040 U.S. Individual Income Tax Return 2024**  
Department of the Treasury—Internal Revenue Service  
OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2024, or other tax year beginning \_\_\_\_\_, 2024, ending \_\_\_\_\_, 2024. See separate instructions.

Your first name and middle initial: **Name** Last name: \_\_\_\_\_ Your social security number: **xxx xx 1111**

If joint return, spouse's first name and middle initial: \_\_\_\_\_ Last name: \_\_\_\_\_ Spouse's social security number: \_\_\_\_\_

Home address (number and street). If you have a P.O. box, see instructions. Apt. no. \_\_\_\_\_ Presidential Election Campaign:  You  Spouse

City, town, or post office. If you have a foreign address, also complete spaces below. State: \_\_\_\_\_ ZIP code: \_\_\_\_\_

Foreign country name: \_\_\_\_\_ Foreign province/state/county: \_\_\_\_\_ Foreign postal code: \_\_\_\_\_

Filing Status:  Single  Head of household (HOH)  Married filing jointly (even if only one had income)  Check only

**Digital Assets** At any time during 2024, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.)  Yes  No

z Add lines 1a through 1h	1z
2a Tax-exempt interest	2a
3a Qualified dividends	3a <b>366</b>
4a IRA distributions	4a
5a Pensions and annuities	5a
6a Social security benefits	6a
c If you elect to use the lump-sum election method, check here (see instructions) <input type="checkbox"/>	
7 Capital gain or (loss). Attach Schedule D if required. If not required, check here <input type="checkbox"/>	7
8 Additional income from Schedule 1, line 10	8 <b>75,958</b>
9 Add lines 1z, 2b, 3b, 4b, 5b, 6b, 7, and 8. This is your <b>total income</b>	9 <b>76,324</b>
10 Adjustments to income from Schedule 1, line 26	10 <b>21,021</b>
11 Subtract line 10 from line 9. This is your <b>adjusted gross income</b>	11 <b>55,303</b>
12 <b>Standard deduction or itemized deductions</b> (from Schedule A)	12 <b>14,600</b>
13 Qualified business income deduction from Form 8995 or Form 8995-A	13 <b>2,747</b>
14 Add lines 12 and 13	14 <b>17,347</b>
15 Subtract line 14 from line 11. If zero or less, enter -0-. This is your <b>taxable income</b>	15 <b>37,956</b>

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form 1040 (2024)

Draft as of June 21, 2024

<b>SCHEDULE 1</b> <b>(Form 1040)</b>	<b>Additional Income and Adjustments to Income</b>	OMB No. 1545-0074	<b>2024</b> Attachment Sequence No. <b>01</b>
Department of the Treasury Internal Revenue Service	Attach to Form 1040, 1040-SR, or 1040-NR. Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.		
Name(s) shown on Form 1040, 1040-SR, or 1040-NR		Your social security number	
<b>Name</b>		<b>xxx-xx-xxxx</b>	
For 2024, enter the amount reported to you on Form(s) 1099-K that was included in error or for personal items sold at a loss . . . . .			
<b>Note:</b> The remaining amounts reported to you on Form(s) 1099-K should be reported elsewhere on your return depending on the nature of the transaction. See <a href="http://www.irs.gov/1099k">www.irs.gov/1099k</a> .			
<b>Part I Additional Income</b>			
<b>1</b>	Taxable refunds, credits, or offsets of state and local income taxes . . . . .	<b>1</b>	
<b>2a</b>	Alimony received . . . . .	<b>2a</b>	
<b>b</b>	Date of original divorce or separation agreement (see instructions):		
<b>3</b>	Business income or (loss). Attach Schedule C . . . . .	<b>3</b>	
<b>4</b>	Other gains or (losses). Attach Form 4797 . . . . .	<b>4</b>	
<b>5</b>	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E . . . . .	<b>5</b>	<b>75,958</b>
<b>6</b>	Farm income or (loss). Attach Schedule F . . . . .	<b>6</b>	
<b>7</b>	Unemployment compensation . . . . .	<b>7</b>	
<b>8</b>	Other income:		
<b>9</b>	Total other income. Add lines 8a through 8z . . . . .	<b>9</b>	
<b>10</b>	Combine lines 1 through 7 and 9. This is your <b>additional income</b> . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 8 . . . . .	<b>10</b>	<b>75,958</b>
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71479F Schedule 1 (Form 1040) 2024			

Schedule 1 (Form 1040) 2024		Page <b>2</b>	
<b>Part II Adjustments to Income</b>			
<b>11</b>	Educator expenses . . . . .	<b>11</b>	
<b>12</b>	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 . . . . .	<b>12</b>	
<b>13</b>	Health savings account deduction. Attach Form 8889 . . . . .	<b>13</b>	<b>4,150</b>
<b>14</b>	Moving expenses for members of the Armed Forces. Attach Form 3903 . . . . .	<b>14</b>	
<b>15</b>	Deductible part of self-employment tax. Attach Schedule SE . . . . .	<b>15</b>	<b>5,366</b>
<b>16</b>	Self-employed SEP, SIMPLE, and qualified plans . . . . .	<b>16</b>	<b>7,605</b>
<b>17</b>	Self-employed health insurance deduction . . . . .	<b>17</b>	<b>3,900</b>
<b>18</b>	Penalty on early withdrawal of savings . . . . .	<b>18</b>	
<b>19a</b>	Alimony paid . . . . .	<b>19a</b>	
<b>b</b>	Recipient's SSN . . . . .		
<b>c</b>	Date of original divorce or separation agreement (see instructions):		
<b>25</b>	Total other adjustments. Add lines 24a through 24z . . . . .	<b>25</b>	
<b>26</b>	Add lines 11 through 23 and 25. These are your <b>adjustments to income</b> . Enter here and on Form 1040, 1040-SR, or 1040-NR, line 10 . . . . .	<b>26</b>	<b>21,021</b>
Schedule 1 (Form 1040) 2024			

Draft as of July 3, 2024

<b>SCHEDULE 2</b> <b>(Form 1040)</b>	<b>Additional Taxes</b>	OMB No. 1545-0074	<b>2024</b> Attachment Sequence No. <b>02</b>
Department of the Treasury Internal Revenue Service	Attach to Form 1040, 1040-SR, or 1040-NR. Go to <a href="http://www.irs.gov/Form1040">www.irs.gov/Form1040</a> for instructions and the latest information.		
Name(s) shown on Form 1040, 1040-SR, or 1040-NR		Your social security number	
<b>Name</b>		<b>xxx-xx-xxxx</b>	
<b>Part I Tax</b>			
<b>1</b>	Additions to tax:		
<b>a</b>	Excess advance premium tax credit repayment. Attach Form 8962 . . . . .	<b>1a</b>	
<b>b</b>	Repayment of new clean vehicle credit(s) transferred to a registered dealer from Schedule A (Form 8936), Part II. Attach Form 8936 and Schedule A (Form 8936) . . . . .	<b>1b</b>	
<b>c</b>	Repayment of previously owned clean vehicle credit(s) transferred to a		
<b>Part II Other Taxes</b>			
<b>4</b>	Self-employment tax. Attach Schedule SE . . . . .	<b>4</b>	<b>10,732</b>
<b>5</b>	Social security and Medicare tax on unreported tip income. Attach Form 4137 . . . . .	<b>5</b>	
<b>16</b>	Recapture of low-income housing credit. Attach Form 8611 . . . . .	<b>16</b>	
(continued on page 2)			
For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 71478U Schedule 2 (Form 1040) 2024			

Schedule 2 (Form 1040) 2024		Page <b>2</b>	
<b>Part II Other Taxes (continued)</b>			
<b>i</b>	Compensation you received from a nonqualified deferred compensation plan described in section 457A . . . . .	<b>17i</b>	
<b>j</b>	Section 72(m)(5) excess benefits tax . . . . .	<b>17j</b>	
<b>k</b>	Golden parachute payments . . . . .	<b>17k</b>	
<b>l</b>	Tax on accumulation distribution of trusts . . . . .	<b>17l</b>	
<b>m</b>	Excise tax on insider stock compensation from an expatriated corporation . . . . .	<b>17m</b>	
<b>n</b>	Look-back interest under section 167(g) or 460(b) from Form 8697 or 8866 . . . . .	<b>17n</b>	
<b>o</b>	Tax on non-effectively connected income for any part of the year you were a nonresident alien from Form 1040-NR . . . . .	<b>17o</b>	
<b>p</b>	Any interest from Form 8621, line 16f, relating to distributions from, and dispositions of, stock of a section 1291 fund . . . . .	<b>17p</b>	
<b>q</b>	Any interest from Form 8621, line 24 . . . . .	<b>17q</b>	
<b>z</b>	Any other taxes. List type and amount: . . . . .	<b>17z</b>	
<b>18</b>	Total additional taxes. Add lines 17a through 17z . . . . .	<b>18</b>	
<b>19</b>	Recapture of net EPE from Form 4255, line 1d, column (l) . . . . .	<b>19</b>	
<b>20</b>	Section 965 net tax liability installment from Form 965-A . . . . .	<b>20</b>	
<b>21</b>	Add lines 4, 7 through 16, and 18. These are your <b>total other taxes</b> . Enter here and on Form 1040 or 1040-SR, line 23, or Form 1040-NR, line 23b . . . . .	<b>21</b>	<b>10,732</b>
Schedule 2 (Form 1040) 2024			

Draft as of July 1, 2024

Schedule E (Form 1040) 2024 Attachment Sequence No. 13 Page 2

Name(s) shown on return. Do not enter name and social security number if shown on other side. **Your social security number xxx-xx-xxxx**

**Note**

**Caution:** The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

**Part II Income or Loss From Partnerships and S Corporations**

**Note:** If you report a loss, receive a distribution, dispose of stock, or receive a loan repayment from an S corporation, you must check the box in column (e) on line 28 and attach the required basis computation. If you report a loss from an at-risk activity for which any amount is not at risk, you must check the box in column (f) on line 28 and attach Form 6198. See instructions.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see instructions before completing this section.  Yes  No

	(a) Name	(b) Enter P for partnership; S for S corporation	(c) Check if foreign partnership	(d) Employer identification number	(e) Check if basis computation is required	(f) Check if any amount is not at risk
A	Greener Pastures Partnership	P		31-2345678		
B	UPE (unreimbursed partnership expenses)	P		31-2345678		
C						
D						

Passive Income and Loss		Nonpassive Income and Loss	
(g) Passive loss allowed (attach Form 8582 if required)	(h) Passive income from Schedule K-1	(i) Nonpassive loss allowed (see Schedule K-1)	(j) Section 179 expense deduction from Form 4562
A		660	5,500
B			
C			
D			
29a Totals			82,118
b Totals		660	5,500
30 Add columns (h) and (k) of line 29a			82,118
31 Add columns (g), (i), and (j) of line 29b			6,160
32 Total partnership and S corporation income or (loss). Combine lines 30 and 31			75,958

40 Net farm rental income or (loss) from Form 4835. Also, complete line 42 below. 40

41 Total income or (loss). Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Schedule 1 (Form 1040), line 5. 41 75,958

Draft as of May 17, 2024

**SCHEDULE SE (Form 1040) Self-Employment Tax**

Department of the Treasury Internal Revenue Service Attach to Form 1040, 1040-SR, 1040-SS, or 1040-NR. Go to [www.irs.gov/ScheduleSE](http://www.irs.gov/ScheduleSE) for instructions and the latest information.

OMB No. 1545-0074 2024 Attachment Sequence No. 17

Name of person with self-employment income (as shown on Form 1040, 1040-SR, 1040-SS, or 1040-NR) **Your social security number of person with self-employment income xxx-xx-xxxx**

**Note**

Skip line 2 if you use the nonfarm optional method in Part II. See instructions.

2	Net profit or (loss) from Schedule C, line 31; and Schedule K-1 (Form 1065), box 14, code A (other than farming). See instructions for other income to report or if you are a minister or member of a religious order	2	75,958
3	Combine lines 1a, 1b, and 2	3	75,958
4a	If line 3 is more than zero, multiply line 3 by 92.35% (0.9235). Otherwise, enter amount from line 3	4a	70,147
<b>Note:</b> If line 4a is less than \$400 due to Conservation Reserve Program payments on line 1b, see instructions.			
b	If you elect one or both of the optional methods, enter the total of lines 15 and 17 here	4b	
c	Combine lines 4a and 4b. If less than \$400, stop; you don't owe self-employment tax. <b>Exception:</b> If less than \$400 and you had church employee income, enter -0- and continue.	4c	70,147
5a	Enter your church employee income from Form W-2. See instructions for definition of church employee income	5a	
b	Multiply line 5a by 92.35% (0.9235). If less than \$100, enter -0-	5b	
6	Add lines 4c and 5b	6	70,147
7	Maximum amount of combined wages and self-employment earnings subject to social security tax or the 6.2% portion of the 7.65% railroad retirement (tier 1) tax for 2024	7	168,600
8a	Total social security wages and tips (total of boxes 3 and 7 on Form(s) W-2) and railroad retirement (tier 1) compensation. If \$168,600 or more, skip lines 8b through 10, and go to line 11	8a	
b	Unreported tips subject to social security tax from Form 4137, line 10	8b	
c	Wages subject to social security tax from Form 8919, line 10	8c	
d	Add lines 8a, 8b, and 8c	8d	
9	Subtract line 8d from line 7. If zero or less, enter -0- here and on line 10 and go to line 11	9	168,600
10	Multiply the smaller of line 6 or line 9 by 12.4% (0.124)	10	8,698
11	Multiply line 6 by 2.9% (0.029)	11	2,034
12	Self-employment tax. Add lines 10 and 11. Enter here and on Schedule 2 (Form 1040), line 4, or Form 1040-SS, Part I, line 3	12	10,732
13	Deduction for one-half of self-employment tax. Multiply line 12 by 50% (0.50). Enter here and on Schedule 1 (Form 1040), line 15	13	5,366

Draft as of October 3, 2023

Form **8995** **Qualified Business Income Deduction Simplified Computation** OMB No. 1545-2294

Department of the Treasury Internal Revenue Service Attach to your tax return. Go to [www.irs.gov/Form8995](http://www.irs.gov/Form8995) for instructions and the latest information.

2024 Attachment Sequence No. 55

Name(s) shown on return **Your taxpayer identification number xxx-xx-xxxx**

**Note:** You can claim the qualified business income deduction only if you have qualified business income from a qualified trade or business, real estate investment trust dividends, publicly traded partnership income, or a domestic production activities deduction passed through from an agricultural or horticultural cooperative. See instructions.

Use this form if your taxable income, before your qualified business income deduction, is at or below \$191,950 (\$383,900 if married filing jointly), and you aren't a patron of an agricultural or horticultural cooperative.

	(a) Trade, business, or aggregation name	(b) Taxpayer identification number	(c) Qualified business income or (loss)
i	Greener Pastures Partnership	31-2345678	13,733*
ii			
iii			
iv			
v			

2	Total qualified business income or (loss). Combine lines 1i through 1v, column (c)	2	13,733
3	Qualified business net (loss) carryforward from the prior year	3	
4	Total qualified business income. Combine lines 2 and 3. If zero or less, enter -0-	4	13,733
5	Qualified business income component. Multiply line 4 by 20% (0.20)	5	2,747
6	Qualified REIT dividends and publicly traded partnership (PTP) income or (loss) (see instructions)	6	
7	Qualified REIT dividends and qualified PTP (loss) carryforward from the prior year	7	
8	Total qualified REIT dividends and PTP income. Combine lines 6 and 7. If zero or less, enter -0-	8	
9	REIT and PTP component. Multiply line 8 by 20% (0.20)	9	
10	Qualified business income deduction before the income limitation. Add lines 5 and 9	10	2,747
11	Taxable income before qualified business income deduction (see instructions)	11	40,703
12	Enter your net capital gain, if any, increased by any qualified dividends (see instructions)	12	40,703
13	Subtract line 12 from line 11. If zero or less, enter -0-	13	
14	Income limitation. Multiply line 13 by 20% (0.20)	14	8,141
15	Qualified business income deduction. Enter the smaller of line 10 or line 14. Also enter this amount on the applicable line of your return (see instructions)	15	2,747
16	Total qualified business (loss) carryforward. Combine lines 2 and 3. If greater than zero, enter -0-	16	
17	Total qualified REIT dividends and PTP (loss) carryforward. Combine lines 6 and 7. If greater than zero, enter -0-	17	

For Privacy Act and Paperwork Reduction Act Notice, see instructions. Cat. No. 37806C Form 8995 (2024)

**\*Qualified business income computation**

Type of income/deduction	Location	Amount	Allocation <sup>1</sup>	Total
Business income	Schedule K-1, line 1	\$23,813		\$23,813
Section 179 deduction	Schedule K-1, line 12	5,500		(5,500)
Allocated 1/2 SE tax deduction	Schedule 1 (Form 1040), line 15	5,366	.23240	(1,247)
Allocated SE SIMPLE deduction	Schedule 1 (Form 1040), line 16	7,605	.23240	(1,767)
Allocated SE health insurance deduction	Schedule 1 (Form 1040), line 17	3,900	.23240	(906)
UPE	Schedule E (Form 1040), line 28B	660		(660)
<b>Qualified business income</b>				<b>\$13,733</b>

<sup>1</sup> Allocation percentage = 1 -  $\frac{\text{Guaranteed payments (Schedule K-1, line 4c)}}{\text{SE taxable income (Schedule E, line 32)}}$