

2009
PARTNERSHIPS

BY

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DISCLAIMER

This course is not for the preparation of Partnership returns.

This course is to acquaint the preparer of Personal Income Tax Returns with the Partnership information necessary to understand the Partnership application to the Personal Return.

Tax Educators correspondence courses are designed for CONTINUING education. The courses are ADVANCED BASIC and not approved for the BASIC course that is required to sit for the Oregon PREPARER exam.

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Courses are updated annually when new forms are available and are maintained at Federal tax laws that pertain to the current TAX year and the same law that the Oregon Consultants Exam covers.

Acknowledgments

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PARTNERSHIPS

DEFINITION OF PARTNERSHIP

Relationship existing between two or more persons who join together to carry on a trade or business.

Each person contributes money, property, labor, or skill and expects to **share in the profits and losses of the business.**

Include: syndicate, group, pool, joint venture, or other unincorporated venture that is carrying on a business and may not be classified as a trust, estate, or corporation.

Factors used to determine if parties intend to be partnership

- ✓ Parties' conduct in carrying out the provisions of the partnership agreement
- ✓ Testimony of disinterested persons
- ✓ Relationship of parties
- ✓ Control each has over income and purpose for which income is used

A joint undertaking merely to share expenses is not a partnership

(Example: Neighbors agree to share expense of fence)

Mere co-ownership of property that is maintained and leased or rented does not necessarily constitute a partnership.

If co-owners provide SERVICES to tenants- partnership exists.

Husband and Wife partnerships

If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a written partnership agreement.

A partnership does not exist and a partnership return is not required if one spouse is an employee or an independent contractor working for the other.

PARTNERSHIPS

PITFALLS OF PARTNERSHIP

- Liability: General partners liability is unlimited whereas limited partners are only liable to extent of their investment.
- Management Responsibilities - allocating and settling disputes between partners
- Continuity of business at death or disability of one of the partners.

TAXATION IN GENERAL

- A partnership pays no income tax
- Must file separate form 1065 return and ALL required attachments
- Failure to file or failure to file a **complete** return is subject to penalty of \$50 PER MONTH **per partner** up to maximum of 5 months
- All income and deductions are passed through to partners to be reflected on their individual returns in appropriate places.

TAX YEAR

A partnership generally is required to adopt the same taxable year as that of the partners owning a majority of the interest in the partnership capital or profits.

If partners owning a majority do not have same tax year, partnership must adopt tax year of the principal partners.

If majority or principal rules above do not apply, the partnership **must** use a calendar year (Year ending 12-31)

ELECTRONIC FILING REQUIREMENT

Partnerships with more than 100 partners are generally required to file tax returns electronically.

PARTNERSHIPS

PARTNERSHIP AGREEMENT

- What the partners agree to
- Oral OR written
- Including any oral or written modifications of original agreement which are agreed to by all partners or adopted in any other manner provided in the partnership agreement.
- Modifications may be made prior to or on the due date of the tax return (not including extensions)
- If agreement is silent on any matter, local law prevails.

A written partnership agreement accurately reflecting the partnership's purposes and goals and the interests, rights, duties, powers and liabilities of the partners, is **VIRTUALLY A NECESSITY**.

A partnership **may** exist without any agreement, written or oral, with state laws supplying the operative terms.

This may be relied on as a **temporary** expedient where two **completely compatible** individuals, who have known each other for a long time, decide to go into what appears to be a one-shot venture. It may even be relied on where such individuals have longer term goals, but consider it expedient to seize an opportunity and engage in business transactions before they have time to sit down with counsel and other advisors to put together a formal agreement.

PROCEEDING ON THIS BASIS, HOWEVER, CAN BE HAZARDOUS!!!

PARTNERSHIPS

PARTNERSHIP AGREEMENT

If the partners disagree, one or both may find themselves occupying legal positions that they never contemplated.

Absent a written agreement, death or disability of a partner can not only result in termination of the agreement, temporary shut down of operations until reorganization, and of income during that period, it may result in the heirs of the deceased/disabled becoming partners in future operations.

ALTHOUGH YOU ANTICIPATE NO PROBLEMS BETWEEN THE ORIGINAL PARTNERS----

- ✓ Will you and the other partner's wife/husband and children be compatible partners
- ✓ Do you want five minor children as your partners?
- ✓ If your partner and his/her spouse file for divorce, will your partnership be involved in the settlement?

PARTNERSHIPS

PARTNERSHIP AGREEMENT ITEMS TO BE INCLUDED OR CONSIDERED

◆ **Parties to the agreement**

◆ **Partnership name**

Any name except one prohibited by law or disallowed by assumed business name authorities.

Some states require that partnership's name be filed.

Professional partnerships (Doctors, CPAs, Attorneys) may have additional restrictions as to names they may use.

◆ **Purpose**

Make clear the purpose for which the partnership was created, but not limited so that the partnership can not expand into other areas as needed.

◆ **Principal place of business**

Indicate principal place and specify that partnership may open at other locations in the future.

◆ **Duration**

Partners should decide if they want the partnership to last for a specific period of time or whether they want the partnership to be at will.

Provision should be made for withdrawal, retirement, expulsion or death of any partner and for disposition of the interest of the affected partner and continuance or discontinuance of the partnership among the remaining partners.

Provision should also be made for withdrawal of partner in violation of the agreement.

PARTNERSHIPS

PARTNERSHIP AGREEMENT ITEMS TO BE INCLUDED OR CONSIDERED

- ◆ **Noncompete-Withdrawal**

Consider non-compete agreement in appropriate circumstances. (If provision is made for withdrawal of partner in violation of agreement, per above #5 and no provision for non-compete, it is VERY likely that the removed partner will be your competition very shortly after his removal from the partnership unless non-compete agreement is in force.)

- ◆ **Management**

All partners are entitled to an EQUAL voice in management of the partnership unless the agreement otherwise provides. Day to day management may be entrusted to a specified managing partner or partners, with power to make specified fundamental changes reserved to the partners as a whole or to some specified percentage of them.

- ◆ **Assignment of Interest**

Under applicable partnership law, an assignment by a partner of his interest in a partnership does not give the assignee any voice in the management or administration of the partnership (unless the partnership agreement otherwise provides), but merely entitles the assignee to receive the profits to which the assignor otherwise would be entitled to.
(Uniform Partnership Act Sec. 27(1).

- ◆ **Who can be a Partner**

Professional partnership may be required to limit members to state licensed practitioners of the particular profession.
Absent legal requirements, ETHICAL considerations may effectively bar income splitting by professionals with nonprofessionals.

- ◆ **Initial Contributions to the Partnership**

Agreement should recite the cash, property or services that each partner has contributed to formation of the partnership. Provisions should be made for valuation of noncash contributions and for effect of failure to make required contributions.

- ◆ **Withdrawals of Capital Accounts**

Provisions limiting withdrawal of capital.

PARTNERSHIP AGREEMENT

ITEMS TO BE INCLUDED OR CONSIDERED

- ◆ **Additional Capital Contributions**
Amounts of same and when they are to be made.

- ◆ **Accounting and Records**
Method of Accounting
Taxable Year
Location of records

- ◆ **Salaries**
What, if any, salaries are to be received beyond the distributive share in profits.

- ◆ **Profits and Losses**
Normally - shared in proportion to capital contribution
MAY share profits in any way partner's decide
Losses generally shared in same way as profits

Individuals who become partners by contributing services may be exempt from sharing in partnership losses.

This is a vital consideration since allocation of profits and losses for tax purposes becomes a complicated matter.

Partnerships should take into consideration the passive activity rules as well as the “at risk” rules for tax purposes when providing for the allocation of losses in particular..

- ◆ **Retirement of a Partner**
Return of capital contribution retiring partner will receive
What payments he will receive
Source of such payments (such as buy-sell agreement, or insurance)
Right of retiring partner to work for the partnership
Non-compete agreements
Life insurance on partners should be considered at this point

PARTNERSHIP AGREEMENT

ITEMS TO BE INCLUDED OR CONSIDERED

◆ **Withdrawal or Expulsion of a Partner**

Indicate how a partner can voluntarily withdraw
What constitutes grounds for expulsion
(Such as professional misconduct, personal bankruptcy etc.)
Provision for distributions to partner who withdraws or is expelled.

◆ **Death of a Partner**

Provision for return of capital, payments received, source of such payments, continuance of business.
PARTNERSHIP LIFE INSURANCE.

◆ **Dissolution of Partnership**

Events that will lead to dissolution
Responsibility for winding up partnership affairs
Responsibility for paying creditors

◆ **Applicable law**

Indicate what state law will govern in case of disputes

◆ **Arbitration**

Arbitration can be speedier and less costly for resolving disputes than litigation. If partners prefer arbitration, an arbitration provision should be included in the agreement.

ORGANIZATIONAL COSTS

NEW FOR 2004 and forward??

The American Jobs Creation Act of 2004 provides that taxpayers may elect to deduct up to \$5,000, reduced by the amount by which cumulative organizational expenditures exceed \$50,000, of organizational expenditures in the tax year in which the trade or business begins, and may amortize the remainder over a 15-year period. Code §709, amended by Pub. L. 108-357, American Jobs Creation Act of 2004, Section 902.

Capitalized expenditures for actual partnership formation can be amortized over a minimum of 60 months.

Legal fees for agreements, Filing fees, Related costs

Must make an election to do so!!

Election only covers expenses incurred during the period that ends with the **unextended** due date of the form 1065 for the year the business commences.

If no election or if organizational expenses are paid or incurred in a subsequent year, those expenses must be capitalized. They are NOT amortizable. They can only be taken as an ordinary income deduction at the time of disposition of the partnership interest.

START UP COSTS

Expenses which would be deductible under IRC sec 162 if the partnership were actively conducting business must be capitalized and amortized over a minimum of 60 months.

Researching the acquisition or creation of an active trade or business
Creating a new trade or business
Preopening activities (i.e. training, etc.)

Must make an election to do so!!! Attach to form 1065 for the year in which the partnership trade or business begins.

SYNDICATION COSTS

Costs of promoting or selling partnership interests are **non deductible, non amortizable.** They are charged to capital and added to basis. They are **not** ordinary deductions upon disposition of the partnership interest. They affect only capital gain or loss upon disposition.

CONTRIBUTIONS TO PARTNERSHIP

CONTRIBUTIONS OF CASH OR PROPERTY

Subject to certain exceptions, no gain or loss is recognized by a partnership or any of its partners on a contribution of cash or other property to the partnership in exchange for an interest therein (IRC Sec. 721(a)).

This is true whether the contribution is made at time of formation or at later date. (Reg. 1.721-1(a)).

EXCEPTIONS-CONTRIBUTION CAN RESULT IN TAXABLE EVENT:

- Gain may be recognized where the partnership assumes liabilities of the contributor or takes property subject to liability.
- Non recognition rule does not apply where the partnership is like an investment company
- Existing partners may be taxed where their shares of partnership liabilities and receivables decrease.
- Special allocation rule applicable if property with built-in gains or losses is contributed.

CONTRIBUTIONS TO PARTNERSHIP

LIABILITY ASSUMED OR TAKEN SUBJECT TO

If partnership assumes liabilities of the contributor or takes the property subject to a liability:

The portion of the indebtedness assumed by the **other** partners is deemed a **distribution** of money to the contributor and **reduces his** basis. The indebtedness assumed by the other partners is treated as a contribution of cash by them and **increases their basis** in the partnership interests.

Contributor will have GAIN to the extent that the assumed liability exceeds HIS basis immediately before the contribution.

Exception - Investment Company

The non-recognition rules do **not** apply and **gain must be recognized** on contribution of **appreciated property** to a partnership in exchange for interest if the partnership would be considered an investment company if it were incorporated (IRC Sec. 351).

Partnership is **treated** as an investment company, if, after the exchange, more than 80 percent of the value of its assets (excluding cash and nonconvertible debt obligations) are held for investment **and** are readily marketable stocks or securities, or interests in regulated investment companies or real estate trusts.

Committee reports indicate that gain is recognized only if the transfer results in diversification of the transferor's interests.

CONTRIBUTIONS TO PARTNERSHIP

INCREASE OR DECREASE IN LIABILITIES AND RECEIVABLES

Existing partners may be taxed where their share of liabilities and receivables decrease.

Where a new partner assumes a portion of the partnership's existing liabilities and is allocated a portion of the existing unrealized receivables, existing partners may be in receipt of ordinary income.

Example: Three equal partners.

Value of each partner's interest is \$2500 and each partner's basis is 2,100. The partnership has \$6,000 of liabilities and \$2,400 of unrealized receivables with zero basis.

Each partner shares equally in these items.

Fourth person buys a 25% interest in the partnership for \$2,500.

He shares equally in liabilities and receivables.

After 4th partner entry, each ORIGINAL partner's share of liabilities is \$1500 (down from \$2,000) and each ORIGINAL partner's share of unrealized receivables is \$600 (down from \$800).

Each of the ORIGINAL partners is treated under IRC SEC. 752(b) as having received a cash distribution of \$500 (the amount of decrease in each partner's share of liabilities) , of which \$200 (the amount of decrease in each partner's share of unrealized receivables) is treated as ordinary income under IRC SEC. 751(b)(1)(B).

The remaining \$300 reduces each original partner's basis to \$1,800. (IRC Sec. 731(a)(1).

If there had been NO decrease in receivables, there would have been NO income, but merely a \$500 reduction in basis.

NEW PARTNER:

No income triggered to him.

His basis in his partnership interest is \$3,400

a) \$2,500 cash

PLUS b) \$1,500 deemed contributed by virtue of

assumption of liabilities in that amount.

LESS \$600. Accounts Receivable Assumed

CONTRIBUTIONS TO PARTNERSHIP CONTINUED

CAUTION:

**JUST ABOUT EVERY ITEM THAT WOULD PRODUCE
ORDINARY INCOME IS INCLUDED WITHIN THE IRC
SEC. 751 DEFINITION OF UNREALIZED RECEIVABLES
INCLUDING**

DEPRECIATION RECAPTURE

SUBSTANTIALLY APPRECIATED INVENTORY

**ALL PARTNERSHIPS CONSIDERING TAKING IN NEW
PARTNERS SHOULD BE AWARE OF THESE
PROVISIONS**

CONTRIBUTIONS TO PARTNERSHIP

PROPERTY WITH BUILT IN GAINS OR LOSSES REQUIRES SPECIAL ALLOCATIONS

Prior to TRA 1984, contributions of appreciated or depreciated property to a partnership could operate to shift the built-in gains or losses to other partners.

TRA '84 for **appreciated property** contributed after March 31, 1984, in tax years ending after that date: IRC 704(c)

Contributing partner will be taxed on built-in gains or loss at the time contribution property is disposed of by the partnership-no longer possible to shift to other partners.

Example: Three equal partners.

A and B each contribute \$40,000 and C contributes land with a fair market value of \$40,000 and a basis of \$10,000. If the partnership sells the land for \$40,000 there is a gain of \$30,000. The entire gain must be allocated to C.

If the property is sold for more than \$40,000, the excess would be allocated to each partner in equal amounts.

Character of contributed property:

Generally the character (capital or ordinary gain) is determined at the partnership level.

However for contributions made after 3-31-84, there are far reaching exceptions to this rule to prevent the conversion of ordinary income into capital gain and capital losses into ordinary deductions through a partnership contribution of property.

Generally, these exceptions and the built in gains/losses rules combine to put a contributing partner in the same position he or she would be in if he or she simply sold the property directly rather than contributing it to the partnership.

CONTRIBUTIONS TO PARTNERSHIP CONTINUED

CONTRIBUTION OF SERVICES

Contribution of services to a partnership in exchange for an interest therein is **not** included in the non-recognition rules. A partnership interest received in exchange for services is a **taxable event** to the contributor and presumably to the partnership itself.

- ◆ Where interest in capital is given, service partner realizes income based on value of the interest at time services are completed. (Reg. 1.721-1(b).
- ◆ Where service partner's interest is limited to **future** profits, the result is not so clear.
 - If there is a **determinable** market value at time of creation, the value of the interest would be currently taxable as ordinary income.
 - Otherwise, a profits only interest is taxable when the risk of forfeiture is gone.

THE SERVICE PARTNER WILL HAVE CURRENT TAXABLE INCOME (*)AND MAY BE WITHOUT CASH TO PAY THE TAX LIABILITY. CONSIDERATION SHOULD BE GIVEN TO PROVIDING SOME CASH AND LESS INTEREST TO REFLECT THE CASH PAYMENT.

BASIS: The amount taxable to a service partner on receipt of an interest in the partnership is added to his basis. (REG. 1.722-1)

GUARANTEED PAYMENT:

Value of capital interest for services rendered is considered as a guaranteed payment and deductible by the partnership if they otherwise qualify as ordinary and necessary business expenses.

***The partner is liable for self employment tax on the payment.**

CONTRIBUTIONS TO PARTNERSHIP CONTINUED

CONTRIBUTIONS OF PROMISSORY NOTES

Regulation 1.704-1(b)(2)(iv)(d)(2)

No credit to capital account is allowed for partner notes!

Contributing partner gets a basis only as payments are made on the notes.

CONTRIBUTION OF RECAPTURE PROPERTY

Recapture income recognized upon contribution of the recapture property **only when the partner making the contribution has a reduction in liabilities** (deemed distribution).

When asset is sold later, recapture rules apply and recapture is allocated to the parties in the “same proportion as the total gain is allocated”.

Other partners must recognize ordinary income for depreciation previously taken by the contributing partner.

BASIS IN PARTNERSHIP INTEREST

ADJUSTED BASIS OF PARTNERSHIP INTEREST:

Determined without regard to any amount shown on Partnership books.

Partner's tax basis is not always determinable using form 1065

Schedule M2 and item J on form K-1 will not necessarily report tax capital

Limited partnerships - K1 may show a negative capital account but there may be suspended losses. When the partnership ends, taxpayer adds suspended losses to the negative capital account before recognizing income because of the deficit restoration rules.

BASIS TO PARTNER AND PARTNERSHIP

Partnership basis in property contributed is the SAME as the PARTNER'S basis in the property prior to contribution. (IRC Sec 723.)

Partner's basis in his partnership interest is amount of money contributed plus the BASIS of any property contributed. (IRC Sec. 722).

Basis is further increased by any gain recognized to the partner at the time of contribution under investment company exception.

BASIS IN PARTNERSHIP INTEREST

INSIDE BASIS

Partnership's tax basis in each asset

OUTSIDE BASIS

Partner's tax basis in his/her interest in the partnership. The partner's investment for tax purposes.

Outside basis should be calculated annually and recorded in record keeping to stay on top of all additions and reductions.

General tax basis rules apply if the interest is acquired by purchase, gift, inheritance, or other transfer

Additions to initial outside basis:

Taxable and non taxable income allocated to the partner
Excess of deductions for depletion over the basis of the depletable property
Partner's share of an investment credit recapture adjustment to any partnership property basis that was reduced when credit was taken
Increase in the partner's share of liabilities

Reduction of initial outside basis:

Withdrawals of money by the partner
Distributions of property to the partner - use adjusted basis in the hands of the partnership
Non deductible non capital expenditures
Deductions for oil and gas depletion
The partner's distributive share of partnership losses (including capital losses and deductible expenses)
Decrease in partner's share of liabilities

NEW IN 2004 AND AFTER

The American Jobs Creation Act of 2004 provides generally that the basis adjustment rules under Code §743 are mandatory, not elective, in the case of the transfer of a partnership interest with respect to which there is a substantial built-in loss. Code §743, amended by Pub. L. 108-357, American Jobs Creation Act of 2004, Section 833.

OUTSIDE BASIS OF PARTNER'S INTEREST

Partner	Tax year	
Partnership		
1.	Partner's previous basis as of _____ (date).....	\$ _____
	Share of liabilities as of this date _____	
2.	<u>Increases to basis since above date:</u>	
	a. Additional contribution of money and adjusted basis of property by the partner to the partnership	\$ _____
	b. The partner's share of both taxable and nontaxable income	\$ _____
	c. Excess of deductions for depletion over the basis of the depletable property	\$ _____
	d. Partner's share of an investment credit recapture adjustment to any partnership property basis that was reduced when the credit was taken	\$ _____
	e. Increases in partner's share of liabilities	\$ _____
	f. Other adjustments.....	\$ _____
3.	Subtotal	\$ _____
4.	<u>Decreases in basis since above date:</u>	
	a. Decrease in partner's share of liabilities.....	\$(_____)
	Subtotal (Cannot be less than zero)	\$ _____
	b. The amount of money and adjusted basis of property distributed to the partner by the partnership	\$(_____)
	Subtotal (Cannot be less than zero).....	\$ _____
	c. Nondeductible partnership expenses that are not capital expenditures	\$(_____)
	Subtotal (Can not be less than zero).....	\$ _____
	d. Other adjustments	\$(_____)
	Subtotal (can not be less than zero)	\$ _____
	e. The amount of any deduction for oil and gas percentage depletion....	\$(_____)
	f. The partner's distributive share of the partnership losses (Including capital losses and deductible expenses).....	\$(_____)
	Subtotal (e and f)	\$ _____
	<u>Amount deductible (not more than subtotal at (d) above</u>	\$(_____)
	<u>Suspended losses (4" F" less line 5).....</u>	\$(_____)
	<u>Adjusted basis (cannot be less than zero) as of _____ (date).....</u>	\$ _____
	<u>Share of liabilities as of this date _____</u>	

PARTNERSHIP TAX CONSIDERATIONS

A partnership is **not** a taxpayer. Tax is paid at **partner** level.

Partnerships must file **information** returns (Form 1065).

Due by 15th of 4th month following close of year.

Extensions: Form 2758

PENALTIES:

Unless the partnership can show reasonable cause for failure to file on time, **including extensions** or failure to show all required information

2008 = \$85. & 2009 = \$90 PER MONTH PER PARTNER FOR EACH MONTH OR FRACTION OF A MONTH - MAXIMUM OF 12 MONTHS.

NOTE: Incomplete Form K-1 Constitutes failure to show all required information and is subject to the above penalty.

Reasonable cause test is met for certain small partnerships (with 10 or fewer partners if **all** of the following apply:

- a. Each partner is a natural person (other than a nonresident alien) or an estate
- b. There are no specially allocated items
- c. All partners have fully reported their shares from the partnership on their timely filed individual income tax returns.

OTHER PENALTIES

1. Failure to furnish copies of Schedule K1 (form 1065) to the partners unless the failure to furnish copies was due to reasonable cause and not willful neglect
2. For not supplying a TIN, not furnishing information on tax shelters, and promoting abusive tax shelters
3. Criminal penalties may be imposed for willful failure to file, tax evasion, or making a false statement.

AMENDED PARTNERSHIP RETURNS (Form 1065) Require that all partner's K-1s be amended and each partner's INDIVIDUAL return be amended accordingly.

PARTNERSHIP TAX CONSIDERATIONS

ITEMS THAT MUST BE SEPARATELY STATED ON PARTNERSHIP RETURN

- ▶ Short term capital gains and losses
- ▶ Long term capital gains and losses
- ▶ Gains and losses from sale or exchange of Sec. 1231 property (property used in trade or business or involuntarily converted)
- ▶ Charitable contributions that can be deducted as itemized
- ▶ Dividends that may be deducted by corporate partners
- ▶ Taxes partnership has paid or accrued to foreign countries so that the partner may elect the deduction or the credit
- ▶ Items of gain, loss, deduction or credit as provided by regulations, including bad debt recovery, prior taxes and delinquency accounts, non business expenses, items subject to special allocation per the partnership agreement, and gain or loss on certain distributions of substantially appreciated inventory or unrealized receivables to partners.
- ▶ Travel, meals or entertainment expenses after 1986.
- ▶ Taxable income or loss, not including items that require separate computation as listed above.

PARTNERSHIP TAX CONSIDERATIONS

ITEMS NOT DEDUCTIBLE IN ARRIVING AT PARTNERSHIP TAXABLE INCOME

- ▶ **Personal exemptions**
- ▶ **Charitable contributions**
- ▶ **Taxes paid to foreign countries**
- ▶ **Depletion of oil and gas wells**
- ▶ **Net operating loss deduction**
- ▶ **Certain itemized deductions for individuals**
- ▶ **Capital loss deduction carryover**

PARTNERSHIP TAXATION

PARTNER'S PAYMENT OF PARTNERSHIP EXPENSES

Unless partnership agreement requires partner to pay certain expenses of the partnership from his own funds, generally a partner may NOT claim partnership expenses against his INDIVIDUAL income.

If no agreement, the payment is considered a contribution to capital and the deduction is taken by the partnership.

If required by the partnership agreement to pay, out of his or her personal funds, certain business expenses deductible by a partner, the partner can deduct that payment as a business expense.

Trade or business partnership expenses are deductible on Schedule E of form 1040.

PARTNERSHIP ELECTIONS

It is generally up to the partnership to make any elections that affect the taxable income of the partnership. Elections available to the partnership:

- ◆ Taxable year
- ◆ Method of Accounting
- ◆ Depreciation Methods
- ◆ Expensing limited amounts of business property
- ◆ Inventory valuation method
- ◆ Treatment of proceeds received in condemnation

PARTNER'S DISTRIBUTIVE SHARE

Allocation regardless of whether or not partnership actually makes any distribution, allocated according to the partnership agreement. Where the agreement fails to provide for allocation, they are determined according to the partner's interest in the partnership.

**This is a most often misunderstood item for partners in a new business
Partners should be made aware of the fact that they may be taxed on income
even if they received no cash. Provisions for the distribution of cash to the
partner's to satisfy tax liability are vital**

PARTNERSHIP TAX CONSIDERATIONS

GUARANTEED PAYMENTS

Payments made by partnership to a partner for services OR for the use of capital which are made without regard to partnership income. IRC 707(c).

Taxable to recipient partner as ordinary income.

Deductible by partnership if they otherwise qualify as ordinary/necessary business expenses.

Subject to Self Employment Tax (Partner) if for services.

DEALINGS AMONG PARTNERS

Loans from partner:

Alternative to direct contribution

Does not have priority over loans from unrelated creditors

Does have priority over repayment of capital contributions

Sale of property by partner or partnership

If partner sells property to partnership for current value, the transaction is treated as occurring between a non-partner and the partnership. Partner must recognize gain on the sale.

Leasing alternative

Partner may lease property to the partnership.

PARTNERSHIP TAX CONSIDERATIONS

LIMITATIONS ON LOSSES

The amount of partnership loss that a partner may deduct is subject to three limitations:

- **Basis**

Partner's share of partnership loss is deductible only to the extent of his **outside** basis in his partnership interest at **end** of the partnership's taxable year in which the loss occurred. The disallowed losses can be carried over until the partner has sufficient basis to take the deduction.

- **At Risk Rules (IRC Sec. 465)**

Apply to all activities except real estate transactions. Limit each partner's losses to the amount that the partner has "at risk" at the **end** of the taxable year.

Amount at risk:

- Amount of money contributed to partnership
- PLUS:
- Basis of property contributed to partnership
- PLUS:
- **Partner's share of any indebtedness for which he has unlimited liability.**
(Amounts protected against loss through nonrecourse financing, guaranteed, stop-loss agreements or similar arrangements are NOT considered to be at risk)

- **Passive Activity Loss Rules.**

Briefly- passive activity is an activity in which the taxpayer does NOT materially participate, rental of tangible property irrespective of material participation. These losses can only be used to offset income from passive activities, not including portfolio income. Suspended losses allowed when interest is sold. This is COMPLEX and is not covered completely in this course.

PARTNERSHIP TAXATION

NEW IN 2004 AND AFTER

The IRS issued final regulations relating to the capital account maintenance rules that expand the rules regarding a partnership's right to adjust capital accounts to reflect unrealized appreciation and depreciation in the value of partnership assets. Reg. §1.704-1(b)(2)(iv)(f)(5)(iii), revised by T.D. 9126.

PARTNERSHIP DISTRIBUTIONS

Generally, gain is recognized on a distribution only if money is distributed in excess of a partner's basis in his partnership interest.

Loss is recognized only in a liquidating distribution.

If property, rather than money, is distributed there is no immediate gain or loss recognition. Gain or loss recognized when partner sells the distributed property.

Exception: Immediate gain triggered if distribution is "ordinary income assets" or liquidating distributions.

TAXATION OF FRINGE BENEFITS (Rev. Rul 91-26)

Fringe benefits provided to partners in return for services are treated as guaranteed payments.

Partnership is entitled to a deduction of any fringe benefit amounts

Guaranteed payments treated as distributive shares of partnership income
(Subject to SE tax)

Partner is permitted to take whatever deduction is permitted.

Accident and health insurance premiums paid on behalf of a partner may be accounted for as a distribution to the partner.

Premiums are **not** deductible by the partnership

Distributive shares of partnership income and deduction are not affected by payment of the premiums.

Partner may deduct the cost of the premiums paid on that partner's behalf to the extent allowed under IRC Sec. 162(1)

GETTING OUT OF THE PARTNERSHIP

Death or retirement of a partner may have both human and economic consequences as well as profound legal and tax consequences.

Under state law, unless the partnership agreement otherwise provides, the death or retirement of a partner terminates the partnership and requires a distribution of the partnership assets to the partners or their successors in interest.

Possible results:

Severe loss in values through forced sales

Dissipation of going concern and goodwill value

Alternatives to avoid problems:

- ✓ Provide that deceased or retiree's interest can be sold to the remaining partners
- ✓ Provide that his interest can be sold to a new partner
- ✓ Provide that his interest can be liquidated by the partnership.
- ✓ Provide that his estate or successor in interest can continue as a partner.

There are many considerations to be made as to the alternatives chosen

- ✓ The tax consequences to the deceased/retiree if sale to remaining partners.
- ✓ Cash flow consequences to remaining partners if required to buy out since their payments are not tax deductible but cash must be made available for the buy out.

CHANGES IN OWNERSHIP - PARTNERSHIPS

Sale of a Partnership Interest

Partner - Usually capital gain and considered to be a sale of all assets not just one asset, therefore tax rate is based on type of assets sold – or loss unless partnership has section 751 assets
recharacterizing gain or loss as ordinary.
File schedule D and notification of sale.

Partnership-Usually no effect, unless partnership elects a 754 election to make optional basis adjustments; tax year does not close - rather, allocations for share of income or loss up to date of disposition.
File form 8308 attached to form 1065 in year exchange takes place and provide copy of form 8308 to each transferor and transferee - usually by January 31 of calendar year following exchange.

Gift of Partnership Interest

Donor - If partnership has liabilities, transaction is deemed part sale and part gift, assuming partner's share of debt relief is greater than the adjusted basis of the partnership interest being transferred.
Report allocations of K1 on personal return

Donee- Non taxable; donee's basis equal to greater of liabilities assumed or donor's basis in the partnership interest plus any gift tax paid on appreciation

Partnership - Tax year does not close - allocation for share of income or loss reported by donor up to date of gift.
Report gift on gift tax return.

Partnership interest exchanged for corporate stock

Partner- Generally exchanged for stock in new or an existing corporation is non taxable
If exchange does not qualify for section 351(*) treatment, capital gain or loss except for ordinary income or loss on section 751(**) assets.
Schedule D transaction if Section 351 is not met.

Partnership Usually no effect, unless partnership elects a 754 election to make optional basis adjustments
Tax year does not close - allocations for shares of income/loss up to date of disposition.

***Section 351 - no gain or loss recognized if property transferred by one or more persons solely in exchange for stock in such corporation and immediately after the exchange, such person or persons are in control of the corporation**

****Section 751 - unrealized receivables and inventory items.**

CHANGES IN OWNERSHIP - PARTNERSHIPS

Partnership interest exchanged for another partnership interest

Partner - non taxable where exchange within the same partnership unless there is a shift of liabilities causing a deemed distribution in excess of basis.

Taxable if exchange involves interests in **different** partnerships

Capital gain or loss recognition except for ordinary income or loss on section 751 assets.

Partnership Usually no effect unless partnership elects a 754 election to make optional basis adjustments.

Tax year does not close - allocate share of income or loss up to date of disposition.

Retirement of partner in return for liquidating payments

Partner - Generally payments made in excess of partner's interest in partnership property are deemed to be either
A distributive share of partnership income
or Guaranteed payment

Partnership

Usually no effect unless partnership elects a 754 election to make optional basis adjustments.

Tax year does not close - allocations for share of income or loss up to date of disposition - Report on K1

Death of a partner

Partner - Generally payments made in excess of partner's interest in partnership property are deemed to be either
A distributive share of partnership income\
or Guaranteed payment

For partnership years beginning after 12-31-97, the taxable year of a partnership closes with respect to a partner whose entire interest in the partnership terminates.

Decedent's distributive share of partnership income reported on decedent's final form 1040.

Partnership-Usually no effect unless partnership elects a 754 election to make optional basis adjustments.

Tax year does not close - allocations for share of income or loss up to date of disposition. Report on K1

SALE OF PARTNERSHIP INTEREST

Partnership tax year

Does not close unless partnership terminates.

Partnership terminates if:

1. Business converted to a sole proprietorship
2. Within a 12 month period, there is a sale or exchange of 50% or more of the total interest in the partnership capital and profits.

Partner's year

1. Does not close with regard to a partner who sells less than his/her entire interest in the partnership
2. Will close for a partner who sells his/her entire interest which will require:
 - a) Interim closing of books
 - b) Pro rata amount of year's activity, or
 - c) Hybrid method
3. Special rules apply to cash basis partnerships

Suspended losses at time of sale

May be deducted to extent of basis

A partner cannot offset a suspended loss against gain on sale due to basis limitations!

At risk suspended losses may be deducted to the extent of the gain

Passive activity suspended losses may be deducted if there is a taxable disposition of the partner's ENTIRE interest in the activity.

Section 751 assets (Unrealized receivables and inventory items)

Ordinary income must be recognized by selling partner

SALE OF PARTNERSHIP INTEREST

REPORTING REQUIREMENTS

SELLER

1. Must notify the partnership of the sale or exchange within 30 days of the transfer (or if earlier, by January 15 of the following year)
 - a) Transferor's name , address and TIN
 - b) Transferee's name, address, and TIN
 - c) Partnership identification number
 - d) Date of transfer
2. Penalty for failure to notify the partnership of sale is \$50 per required notification.
3. Include sale information on his/her individual income tax return, including his/her computation of 751 gain or loss.
4. Allocate gain or loss according to passive activity loss rules to each activity
 - a) Trade or business
 - b) Rental
 - c) Investment
4. Allocate gain or loss as if partnership had sold its assets on valuation date:
 - a) Beginning of partnerships taxable year in which disposition occurred
 - b) Date of disposition of the partnership interest
 - c) Under some circumstances, day prior to disposition
5. Allocate by ratable portion allocation method
 - a) If net gain:
$$\frac{\text{Gain on activity if sold by partnership}}{\text{Total gain on all appreciated (net gain) activities if sold by partnership}}$$
 - b) If net loss:
$$\frac{\text{Loss on activity if sold by partnership}}{\text{Total loss on all depreciated (net loss) activities if sold by the partnership}}$$

Installment sales - Rev. Rul 89-1-8 - income from sale of a partnership interest may not be reported under installment method to extent it represents income attributable to substantially appreciated inventory (assume including depreciation recapture)

SALE OF PARTNERSHIP INTEREST

REPORTING REQUIREMENTS

Partnership

1. Attach form 8308 (\$50 penalty for failure to file)
 - a) Attach to form 1065
 - b) Separate form 8308 for each section 751 exchange
 - c) Furnish a copy to transferor and transferee partners by January 31 of the year following the sale or exchange

2. If sale of a publicly traded partnership, no form 8308 must be filed. Instead, the sale is reported on a 1099-B.

3. Make necessary disclosures on forms K1 of the:
 - a) Selling partner
 - Close out of capital account
 - Seller's share of unrealized receivables and substantially appreciated inventory
 - b) Purchasing partner - provide partner with a statement with enough basis information to allow partner to compute elections.

SALE OF PARTNERSHIP INTEREST

IRC SECTION 754 ELECTION

Election to adjust inside basis in assets upon sale or exchange of a partnership interest.

Election made by attaching a statement to the partnership tax return by due date (including extensions) for year during the year of the sale.

Election corrects the distortion between inside basis and outside basis.

Increase inside basis by any gain recognized by selling partner

Decrease inside basis by any loss recognized by selling partner.

Adjustment equal to:

Purchasing partner's initial basis for partnership interest (outside basis)

Less

Purchasing partner's proportionate share of adjusted basis of the property (inside basis)

Allocate adjustment among partnership assets. Divide assets into two classes of property:

Capital Gain property and Ordinary income property

A step up can only be allocated to properties with $FMV > \text{basis}$

A step down can only be allocated to properties where $FMV < \text{basis}$

Attach results to tax return.

Disadvantages:

2. Risk of negative adjustment on sale at a loss
3. Bookkeeping - making separate calculation for purchasing partner each time partnership realizes income and incurs expenses.

Election is revocable only by IRS permission.

GETTING OUT OF THE PARTNERSHIP

WHAT ABOUT PROBATE OF A PARTNERSHIP INTEREST?

A partnership generally terminates upon the death of one of the partners, the value of his or her interest merging with the rest of his or her estate for distribution to heirs along with other assets in compliance with the instructions of his will, or, if no will, in accordance with the laws of the state in which he lived.

THE DEATH OF A PARTNER CAN HAVE A VERY DISRUPTIVE EFFECT UPON THE SURVIVING PARTNERS AND THEIR BUSINESS, PARTICULARLY IF THERE IS NO PROPERLY FUNDED BUY/SELL AGREEMENT.

THESE PROBLEMS CAN BE WORSE IF THE PROBATE ESTABLISHMENT STARTS MAKING MOUNTAINS OUT OF LEGAL MOLEHILLS.

Surviving partners need time to rearrange the business affairs, reassign the duties and responsibilities of the deceased or incapacitated individual and/or find a replacement.

Surviving partners need to have someone they can deal with IMMEDIATELY.

If the deceased interest in the partnership becomes a part of his general estate, it may be two or three YEARS or longer before the surviving partners find out who they can deal with and who is to receive the interest.

It is important that a partner's interest be promptly transferred to a SPECIFIED beneficiary at his death.

POSSIBLE SOLUTION - LIVING TRUST

A partnership interest can be placed in a living trust of which the partner is the trustee. A trust will not die and therefore there is no required dissolution of the partnership. At the instant of death, the Successor Trustee steps into the shoes of the deceased and the transition will be a smooth one.

The beneficiary named is also the successor trustee which insures that the partnership interest goes to the individual chosen by the deceased.

Recommended reading:

"How to Avoid Probate" by Norman F. Dacey.

This valuable book includes forms and instructions to prepare a trust including the above partnership deeds of trust.

FAMILY PARTNERSHIPS

The family business provides opportunities for income-splitting, but careful planning is required. **THE WHOLE IDEA COULD BACKFIRE!!**

In some situations, it may be desirable to make a GIFT of the partnership interest to a family member. Transfer as gift must be full and irrevocable and gift tax paid if applicable.

If properly initiated, the gifted interest will presumably be taxed to a person in a lower bracket. **WARNING, CONSIDER RULES FOR CHILDREN UNDER 14 WHEN MAKING THE CONSIDERATIONS OF FAMILY PARTNERSHIP AND GIFTED INTERESTS.**

INDIVIDUAL RECOGNIZED AS PARTNER IN FAMILY PARTNERSHIP

- Will be recognized if own capital interest in partnership in which capital is a material income-producing factor. (Code Sec. 704(e).
- Establishing Ownership of capital interest:
 - Is it a capital interest
 - Is he really the OWNER of the interest?
 - Does the donor or seller retain real ownership?
- Minors

If the minor can not be shown to be competent to manage his own affairs, he will not be deemed a valid partner. (Reg. 1.704-1(e)(2)(viii))

LIMITED PARTNERSHIPS

State law governs the formation of limited partnerships. The Uniform Partnership Act is in force in many states.

The Act provides that the limited partners are not to be bound by the obligations of the partnership. The liability of the limited partners is limited to their investments, both cash and contractual commitments.

The limited partner enjoys rights:

- ◆ To have the partnership books located at principal office of partnership
- ◆ To inspect and copy books and records
- ◆ To receive full information on all partnership affairs
- ◆ To demand an accounting
- ◆ To demand dissolution and winding up of business by decree

The limited partner occupies a position behind that of general creditors and ahead of the general partners on dissolution.

The Revenue Act of 1987 treats publicly trade partnerships as corporations subject to certain exceptions.

LIMITED PARTNERSHIPS THAT ARE, IN ESSENCE TAX SHELTERS ,SHOULD BE AWARE OF NEW TAX SHELTER REGULATIONS.

PROFESSIONAL PARTNERSHIPS

Special problems and concerns of licensed professionals who join together in a partnership to engage in the practice of their profession require additional special forms and clauses.

PARTNERSHIP CHECKLIST

PARTNERSHIP AGREEMENT

- ✓ Is the partnership a partnership for tax purposes?
- ✓ Are there any special allocations?
- ✓ Do special allocations meet substantial economic effect rules?
- ✓ Are there provisions for guaranteed payments?
- ✓ Are payments to be made to a retired partner or deceased partner's estate and if so, how are they to be made?
- ✓ Are buy-sell agreements provided for and are they current?
- ✓ Does the partnership agreement need revisions?
- ✓ Is it time to incorporate the partnership?
- ✓ If a family partnership, will all partners (especially minors) be recognized for tax purposes?

CONTRIBUTIONS OF PROPERTY TO PARTNERSHIP

- ✓ Has any partner contributed property to partnership?
- ✓ Does tax basis of contributed property differ from Fair Market Value?
- ✓ Should there be special allocation of depreciation, gains, losses.?
- ✓ Are there adequate records to substantiate the amount of built in gains or losses on contributed property and the character of the gain/loss?
- ✓ Did the partnership assume liabilities associated with contributed property?
- ✓ Did any contributing partner recognize gain as a result of the contribution of property subject to a liability?
- ✓ Were any distributions made in connection with the contribution of the property to the partnership?

PARTNERSHIP CHECKLIST

OPERATIONS OF THE PARTNERSHIP

- ✓ Are accounting methods current? Changes in Order?
- ✓ Proper amortization of organization expenses and start up costs?
- ✓ Construction period interest and taxes?
- ✓ Considering partner/s tax positions, should steps be taken to accelerate or defer partnership income or expenses?
- ✓ Do the partnership and partners have adequate records to establish the partner's tax basis?
- ✓ Do the partners have sufficient amounts at risk to absorb projected losses?
- ✓ Do Passive Activity Loss rules bar any deduction of losses by the partners?
- ✓ Are depreciation policies producing optimum results for PARTNERS?
- ✓ Has purchase price for real property been properly allocated between land and building?
- ✓ Have lease as opposed to purchase options been considered?
- ✓ Are payments for property or services properly classified?
- ✓ Are payments to partners and members of their families reasonable?
- ✓ Are all travel and entertainment expenses properly documented and substantiated?
- ✓ Has partnership's qualified retirement plan been reviewed to assure continued qualification, especially in light of 86 TRA changes?

PARTNERSHIP CHECKLIST

DISPOSITIONS OF PARTNERSHIP PROPERTY

- ✓ Any installment sales?
- ✓ Imputed interest and Original Issue discount rules considered?
- ✓ Any sales made to a 50% partner?
- ✓ Is timing of sales of assets and effects on partners being considered?
- ✓ Has depreciation recapture been considered in dispositions?
- ✓ Has investment credit recapture been considered in disposition?
- ✓ Have there been any like-kind exchanges or trade-ins?
- ✓ Will proceeds of involuntary conversions be reinvested?
- ✓ Have there been property distributions to partners?
- ✓ Have charitable contributions of property been considered as alternatives to sales?

CHANGES IN PARTNER'S INTERESTS

- ✓ Have new partners been admitted?
- ✓ Has any partner (or trust as partner) sold an interest in the partnership?
- ✓ Has proper allocation of items been made to reflect partners' changes in interest during the year?
- ✓ Has the effect of the assumption of partnership liabilities by a new partner or existing partner been considered?
- ✓ Has any partner received a distribution in liquidation of his interest?
- ✓ Has effect of unrealized receivables and substantially appreciated inventory been taken into account?

PARTNERSHIP AGREEMENT

(The following format is for a general partnership and should be used only as a guideline. We do not hold this out to satisfy all requirements of a partnership agreement and strongly recommend that counsel be consulted for the final drafting of the agreement to be certain all aspects are covered and all new laws have been considered.)

THIS IS A SAMPLE ONLY

GENERAL PARTNERSHIP AGREEMENT

THIS AGREEMENT, made and entered into this _____ day of _____ 20____, between (among) _____, _____, and _____ hereinafter referred to as the Partners.

WHEREAS the parties to this agreement desire to become Partners in the business of _____, IT IS AGREED AS FOLLOWS:

GENERAL PROVISIONS

1. Name. This agreement dated _____ 20____, spells out the terms and conditions of a general partnership to be known as _____

2. Partners. The names and addresses of the partners are:

Name	Address
_____	_____
_____	_____
_____	_____
_____	_____

3. Business. The partnership is formed for legally-permitted business purposes, including, but not limited to _____.

(If the business of the partnership is to be limited to a specific business, the following alternative clause should be used.)

3. Business. The partnership is formed to engage in the business of _____

4. Place of Business. The partnership's principal place of business will be _____, in the City of _____ County of _____ State of _____

5. Duration. The partnership will commence immediately and continue (select appropriate clause)
 until _____, 20____
 for a term of _____years unless terminated sooner by agreement
 between (amount) the Partners and may be extended and continued
 for such additional period of time as the Partners may agree.
 until this business objective has been accomplished:_____

until a terminating event, as described in Part G of this agreement occurs.

6. Assignment. No Partner shall sell, assign, pledge or mortgage his interest in the partnership without the consent of the other partners.

or

6. Assignment. Another person can substitute for, and have the rights of, an original partner under these circumstances:

7. New Partners. Additional Partners can be added to the partnership under these circumstances:

PARTNERSHIP CAPITAL

1. Capital Contributions As initial capital, the Partners have contributed:

Name	Cash Tax Basis	Other Property Fair Mkt.Val.	Total	% of PTNR
_____	_____	_____	_____	_____

2. Return of Property. The property contributed by the Partners becomes partnership property and will not be returned while the partnership is in existence.

or

2. Return of Property. The partnership has the use of the following items of property, which will be returned to the contributing Partner under these circumstances:

Property Contributed by Circumstances of Return

3. Interest on Capital Contributions: Partners will not receive interest on the value of their contributions.

or

3. Interest on Capital Contributions. Partners will receive interest at an APR of _____percent of the value of their contributions.

4. Additional Contributions. The Partners will contribute in equal shares any additional capital that they deem necessary for the operation of the partnership.

or

5. Additional Contributions The Partners agree to make additional contributions to the partnership's capital as follows:

<u>Partner</u>	<u>Amount</u>	<u>Circumstances</u>
----------------	---------------	----------------------

MANAGEMENT

Unless the agreement specifies otherwise, all partners have an equal voice in management. The following are possible clauses governing control of partnership affairs

- Majority Vote.
Partnership decisions will be made by (majority vote of all Partners (or) vote of Partners holding 50 percent or more of the capital interests in the partnership.)

or

- Unanimous Vote.
Partnership decisions will be made by unanimous vote of all the Partners.

or

- Managing Partner.
_____ is the Managing Partner, with primary responsibility for decision-making. The managing partner will consult with the other Partners, but the Managing Partner/s decision will be final except for the following major decisions:

or

- Areas of Expertise.
Each partner has an area of expertise as listed below.
The Partners will discuss all partnership decisions, but Partner's decision in his area of expertise will be final.

<u>Name</u>	<u>Area of Expertise</u>

- Resolution of Disputes.
In case of disagreement, all Partners agree to submit to arbitration under the rules of the American Arbitration Association. The arbitrator's decision will be binding on all Partners, and may be enforced in a court of law. Otherwise, the Partners agree to use arbitration and refrain from litigation in disputes involving matters of partnership business.

or

- Resolution of Disputes. In case of disagreement, the situation will be handled as follows:

SERVICES TO PARTNERSHIP

- Duties.
The Partners will perform services for the Partnership as follows:

Name	Service	Will Devote Full Time to Partnership?
------	---------	---------------------------------------

- Compensation.
Partners agree to look to their share of partnership profits, not salaries, as compensation for their services.

or

- Compensation.
Partners will receive compensation for services to the partnership as follows:

<u>Name</u>	<u>Services</u>	<u>Compensation</u>
-------------	-----------------	---------------------

- Manner of Payment.
The compensation agreed to in paragraph 2 of this Part will be paid in equal (weekly /bimonthly ,monthly, quarterly) installments.

or

- Manner of Payment.
Each partner will be entitled to a drawing account as follows:

<u>Name</u>	<u>Drawing Rights</u>
-------------	-----------------------

Once each (quarter/year) on _____ each Partners entitlement to distributions from the partnership will be computed. If a Partner's entitlement is greater than his draws,the partner will receive a check for the difference within _____days. If the Partner's draws are greater than his entitlement, he agrees to make up the difference within____days.

- Expense Accounts.

Partners are entitled to expense accounts within these limits:
- Insurance. The partnership agrees to maintain liability insurance in the amount of \$_____per partner, to indemnify partners against civil and criminal liability incurred while acting in good faith in the best interests of the partnership.

ALLOCATION OF PARTNERSHIP ITEMS

- Division of Profit and Loss.

All profits and losses of the partnership shall be shared equally among the partners.

or

- Division of Profit and Loss.

All profits and losses of the partnership will be shared among the Partners in proportion to their respective capital contributions as specified in paragraph 1 of Part B of this agreement.

or

- Division of Profit and Loss.

All profits and losses of the partnership shall be shared among the Partners in proportion to their respective capital accounts.

- Special Allocations.

Partner's share of specific partnerships items are as follows:

<u>Name</u>	<u>Item</u>	<u>Percent</u>
-------------	-------------	----------------

- Retention of Profits.

The partnership policy on distribution versus retention of profits is:

ACCOUNTING AND TAX MATTERS

- Calendar Year. The partnership will have a calendar year.

or

- Fiscal Year. The Partnership's fiscal year will run from _____ to _____. The partnership is entitled to use a fiscal year for tax purposes because_____.

- Methods of Accounting. The accounting methods and assumptions used to determine profits, losses, and surplus and capital accounts are:

- Books and Records. The partnership will maintain these books and records.

_____ is responsible for the accuracy of these books and records.

- Inspection. Partners have a right to inspect the books and records under these conditions.

Tax Management Partner _____ is the "tax management partner" for purposes of Internal Revenue Code Sec. 6221-6225.

- Basis Election

The partnership will (elect/not elect) Internal Revenue Code 754 treatment.

- Organizational Expenses The partnership will elect to:

---capitalize organizational expenses

or

--- amortize organizational expenses over a period of _____ months.

CHANGES AND TERMINATION OF THE PARTNERSHIP

- Amendments.
The procedure for amending this partnership agreement is:

- Withdrawal of a Partner.
Any partner may elect to with draw from the partnership upon giving _____notice in writing and on the expiration of such _____period the withdrawal will be effective.
or

- Withdrawal of Partner.
Partners can withdraw from the partnership under these conditions:

- Distribution to Withdrawing Partner.
If any Partner elects to withdraw from this partnership, he shall be entitled to his interest in partnership property, and to the return of the additional capital he contributed to the partnership reduced by his share of any losses sustained up to date of withdrawal becomes effective, and increased by his share of any profits not previously withdrawn which have been earned by the partnership up to date his withdrawal becomes effective.
A withdrawing Partner/s shall not be entitled to payment for any partnership goodwill, but he will be obligated to pay his share of partnership debt.
or

- Distribution to Withdrawing Partner.

On withdrawal, a Partner will receive property described as follows:

- Covenant Not to Compete.

When a Partner withdraws, he agrees to sign a covenant not to compete with the partnership within a _____mile radius of _____
_____ for a period of _____years.

- Expulsion of Partner.

A partner can be expelled from the partnership for one or more reasons:

The procedure for expelling a Partner is:

- Death of Disability of Partner.

A "triggering event" means the death or disability of one or more Partners. For purposes of this agreement, disability means:

When a triggering event occurs, the partnership will be terminated: its business will be wound up, debts paid, and remaining assets distributed to the remaining partners.

or

When a triggering event occurs, there will be a technical dissolution, but the partnership will be continued by the remaining Partners.

The partnership agrees to buy, and each Partner (or his estate) agrees to sell, the partnership interest of the deceased or disabled Partner. The partnership will buy, pay premiums for, and own life insurance and disability income policies on each Partner. The face amount of each policy (to be recomputed annually and coverage added as needed) will equal the value of the Partner's interest. The insurance, payable to the partnership, will be used to buy the Partner's interest.

After one triggering event, this buy-sell provision will remain in effect for the remaining Partners until only one Partner remains. At that time, the buy-sell agreement will lapse.

(Partners may provide for death/disability in a variety of ways.
The above is just one possibility)

- Death of a Partner.

In the event of the death of any Partner, the business will be continued until the end of the year in which the death occurs.

The estate of the deceased Partner will share in the net profits or losses of the partnership for the balance of the year, in the same way the deceased partner would have shared had he survived.

- Election to Continue Interest or Sell.

On the death of a partner, his personal representative may elect to either continue in the partnership or to sell the deceased partner's interest to the surviving Partners.

The election shall be made in writing to the surviving Partners within _____ days after the death of the Partner.

If the personal representative elects to continue in the partnership, the personal representative will succeed to all the rights and bear all the obligations of the deceased Partner under this partnership agreement, except that the personal representative will not be liable for partnership debts in excess of his interest in the partnership assets.

If the personal representative elects to sell the deceased Partner's interest to the surviving Partners, the selling price will be determined as follows:

Payment will be made in the following manner:

- Retirement.

A Partner's retirement will be treated as an implied offer to sell his partnership interest, at a price to be computed as follows:

The terms of the sale will be:

PARTNER-PARTNERSHIP TRANSACTIONS

- Good Faith.

Transactions between the partnership and a Partner acting in a non-Partner capacity are permitted, if the Partner deals fairly with the partnership, using standards applicable to an arm's-length-relationship.

- Law.

This agreement is entered into under the laws of _____
and shall be controlled by the laws of the state of _____

IN WITNESS WHEREOF, the parties have signed this agreement.

ADDITIONAL PARTNERSHIP AGREEMENTS

The partnership may wish to have additional written agreements to cover the following situations:

- Provisions on Management of the Partnership spelling out details of:
 - Who is managing Partner
 - Time required to be served
 - Power and Authority specifically
 - Reports required to be given to Partners
 - Compensation
 - Liability
 - Removal

YOU CAN NOT WALK AWAY FROM A PARTNERSHIP WITHOUT TAX CONSEQUENCES!!

If partner has negative basis - debt relief income is triggered.

Gift of partnership interest subject to gift tax rules.

Unrealized receivables and inventory can create income even if
no cash exchanges hands.

Schedules L, M-1 and M-2 are not required to be completed if the partnership answered YES to question 5 of schedule B.

SCHEDULE L - BALANCE SHEET

Should agree with partnership books and records

The capital account total should be equal to capital accounts beginning and ending of all K1 forms added together!!

SCHEDULE M-1 RECONCILIATION OF INCOME (LOSS) PER BOOKS WITH INCOME (LOSS) PER RETURN

Line 3 - Guaranteed payments other than amounts paid for insurance that constitutes medical care for a partner, partner's spouse, or dependents

Line 4b - Includes the 50% of travel and entertainment not allowed

- Includes expenses for use of an entertainment facility
- Includes the part of business gifts over \$25
- Includes expenses of individual allocable to conventions on cruise ships over \$2,000
- Includes employee achievement awards over \$400
- Includes the part of the cost of entertainment tickets that exceeds face value (also subject to 50% allowance)
- Includes the part of the cost of sky boxes that exceeds face value of non luxury box seat tickets
- Includes part of the cost of luxury water travel not allowed
- Includes expenses for travel as a form of education
- Includes other travel and entertainment expenses not allowed as a deduction.

SCHEDULE M-2 ANALYSIS OF PARTNERS' CAPITAL ACCOUNTS

The amounts on schedule M2 should equal the total of the amounts reported in item J of all the partner's schedule K-1 forms.

NOTE

Although these schedules are not required if conditions are met, be sure to consider the fact that, if completed properly, these schedules are a "check" point to make sure that the return has reported all income and deductions and K1s are correct.

Remember - incomplete returns are subject to penalty!!!

FORM 1065 SCHEDULE K1

Partnership Form 1065

GO TO:

<http://www.irs.gov/pub/irs-pdf/f1065.pdf>

Form K-1

<http://www.irs.gov/pub/irs-pdf/f1065sk1.pdf>

Instructions for Form 1065 & 'K' & 'K-1' & 'M' etc.

GO TO:

<http://www.irs.gov/pub/irs-pdf/i1065.pdf>

CHECK POINTS!

Each item on K1 forms should total together to the same amount on same line on form 1065 Schedule K!!

This is a reconciliation item to prove accuracy of the K1 forms!! Don't forget to check this!!

Partner's account information should equal the amount shown on balance sheet and M-1 and M2 reports.

Debt (recourse and non recourse) on K1 forms should total the debt reported on the balance sheet.

STARTING IN 2006

Transactions with a significant Book-Tax Difference' are removed from the list of reportable transactions. Those that would have been required to be disclosed with due dates after January 5, 2006 are no longer reportable transactions and do not need to be disclosed on Form 8886. 2009