Chapter 1

Overview: Basic Tax Structure of Partnerships and LLCs

Learning objectives

- Distinguish between the various types of partnerships and limited liability companies (LLCs).
- Identify the effects of investor contributions and distributions on their basis in a partnership or LLC interest.
- Determine how partnerships and LLCs opting to be treated as partnerships report their federal taxable income to the IRS and to investors.
- Identify considerations related to the application of the check-the-box rules when electing to treat an entity as a partnership, LLC, or corporation.
- Compute the tax consequences of converting from a corportion to an LLC (or partnership);
- Recognize when pass-through income from a partnership or LLC is subject to the self-employment tax.

What is a partnership for federal income tax purposes?

For tax purposes, a partnership exists when two or more taxpayers join together, without incorporating, to carry on business or investment activities for their mutual (or "joint") benefit. Partnerships can be used to conduct active businesses or to carry on investment activities. Moreover, the partnership can be structured in such a way that some partners participate actively in partnership operations while others play the role of passive investors, content to share in the profits (or losses) derived from partnership operations while playing no active role in day-to-day management activities. The primary strength of the partnership as a vehicle for conducting business is its flexibility. Partners can, for example, agree to share differently in the risks and rewards associated with partnership business activity. Yet, the partnership can still provide limited exposure to business risks for certain of its partners (for example, limited partners), providing the best of both worlds: (*a*) highly flexible arrangements for sharing in the risks and rewards of business activities and (*b*) limited liability for members. Moreover, unlike corporations, partnership income is subject only to one layer of tax-imposed at the partner level. For these reasons, partnerships are the preferred form of organization for a wide variety of business activities.

Partnerships versus other entities

Legal protection

There are several types of partnerships, each with different levels of liability protection for their partners. The first, and most basic, type of partnership is the *general partnership*. In a general partnership, all partners participate in management of the partnership, and all partners have the legal authority to enter into binding legal relationships on behalf of the partnership. Therefore, for example, if a law firm were organized as a general partnership, each of its partners would have the authority to enter into attorney-client relationships on behalf of the firm. Each of the firm's clients, even if they deal with only one attorney, is represented by the partnership, rather than by an individual attorney. The downside to this arrangement is that claims against the firm, even if due to the actions of only one partner, can be enforced against any and all partners of that firm, to the extent that the partnership's assets are insufficient to satisfy the claim.

Example 1-1

In 1990, Leventhal & Horwath, then the eighth largest accounting firm in the United States, filed for bankruptcy protection under pressure from several lawsuits stemming from the failure of many of its audit clients. Like all accounting firms at the time, the firm was organized as a general partnership. The firm eventually dissolved, but its partners remained responsible for damage assessments awarded to claimants against the firm. Most of these partners had not been personally involved in the engagements targeted by the various lawsuits. Nonetheless, in addition to losing their jobs, each of the partners was left with personal responsibility for tens of thousands of dollars of partnership liabilities stemming from the lawsuits that drove the firm out of business. According to published reports, these liabilities generally exceeded the personal assets of most of the partners, meaning that many partners faced the prospect of personal bankruptcy following dissolution of the firm.

Due to concerns about partner liability, it can be very difficult to attract investment capital to businesses organized as general partnerships. Moreover, there are many activities in which it is neither necessary nor desirable for all partners to be involved in management of the partnership or its affairs. For example, partnerships are often used to raise capital to purchase real estate (office buildings, apartment complexes, and the like), or to drill oil or gas wells. These activities require large amounts of money, but do not necessarily require the input of each partner in deciding which properties to acquire or where to drill for oil and gas. Organization of the operating or drilling companies as corporations would alleviate concerns over liability and participation in management but would raise new concerns over double taxation and lack of flexibility. *Limited partnerships* are designed to accommodate the business needs of these activities while still allowing them to be conducted in partnership form.

In a limited partnership, the power to bind the partnership contractually, and to make all management decisions, is vested in the hands of the general partners. Other partners, referred to as limited partners, make capital investments in the partnership but are not allowed to participate in management and cannot enter into binding contracts on behalf of the partnership. Reflecting their restricted ability to influence partnership affairs, these partners are shielded from responsibility for partnership obligations. Full liability for partnership debts rests with the general partners, who control the partnership's actions. Therefore, limited partners are in much the same position as shareholders in a corporation. They invest money in the partnership's business without expressing any voice in how the business is conducted. If the venture is profitable, the partners share in the profits. If it fails, they stand to lose their entire investment. However, their losses are limited to the amounts directly invested in the firm. Unlike a general partner, partnership liabilities do not follow the limited partners individually, and therefore their exposure is limited to the amounts actually invested (or legally pledged) to the firm.

Example 1-2

Last year, Marge invested $10,000 as a limited partner in an oil and gas drilling partnership. The general partner of the partnership was Ted, a business acquaintance of Marge's. Early this year, a mishap on the drilling site caused a fire, which eventually spread to thousands of acres, causing significant losses of livestock and some farm and ranch buildings in the area. The damages resulted in lawsuits against the partnership. Unfortunately, the well being drilled by the partnership turned out to be dry, and the partnership did not have sufficient assets to satisfy the damage assessment resulting from the lawsuit. Although Marge will lose her entire $10,000 investment in the partnership, as a limited partner she has no personal responsibility for the damages awarded against the partnership. In contrast, Ted, the general partner, is personally responsible for the outstanding debts of the partnership. Therefore, in addition to any capital he invested directly in the partnership, Ted will be liable to the farmers and ranchers whose livestock and buildings were lost in the fire started at the drill site.

Knowledge check

1. Midge is a 10% limited partner in Wild Catter, an oil and gas drilling partnership. She received her partnership interest in exchange for a $10,000 investment in the partnership. The balance in her capital account as of the beginning of the current year was $10,000. She has made no additional contributions to the partnership and received no distributions. In January, a pipe burst on one of the partnership's properties and several thousand gallons of crude oil leaked onto surrounding pastureland. The resulting damage rendered the land unusable and rendered all the partnership's assets worthless. The landowner sued the partnership, demanding actual and punitive damages of $2,500,000. Under the terms of the partnership agreement, Midge receives 5% of partnership losses and 10% of partnership profits. She is not obligated to restore deficits in her capital account. What does Midge stand to lose if the suit is successful?

    a. $2,500,000.
    b. $250,000.
    c. $10,000.
    d. $0.

2. In the preceding question, assume that Midge was the only general partner of the partnership, and that the partnership allocated 50% of partnership losses to her, but only 10% of partnership profits. In addition to her initial investment of $10,000, how much would she stand to lose if the lawsuit against the partnership is successful?

   a. $2,500,000.
   b. $1,250,000.
   c. $10,000.
   d. $0.

As noted, a limited partnership offers liability protection to limited partners, whereas general partners remain fully liable for unsatisfied claims of the partnership's creditors. Two other forms of partnerships are available which provide some protection for general partners as well. The first, called a limited liability partnership (LLP), did not exist until after the failure of Leventhal & Horwath discussed in example 1-1. Following the bankruptcy of the nation's eighth largest accounting firm in 1990, states began to yield to the pressure of professional services organizations (principally accounting and law firms) and passed laws allowing for LLPs. In an LLP, the partnership itself remains liable for all the actions taken by its partners and employees. However, individual partners in the partnership are shielded from personal liability for losses caused by the actions of partners other than themselves.[1] That is, each partner is personally responsible for losses or other liabilities stemming from his or her own actions but is shielded from personal risk for the actions of his or her partners. Therefore, in an LLP, every partner enjoys at least some of the protections provided to limited partners in a limited partnership. The partners do not have to give up their voice in management, nor their rights to bind the partnership contractually, however, in order to obtain this protection. The LLP therefore moves a substantial step closer to a corporation in terms of the benefits and protections it provides to its members.

Example 1-3

Carl is a partner in a multi-state accounting firm organized as a limited liability partnership. Two years ago, one of his partners in Florida took a bribe in exchange for rendering a clean audit report on one of the firm's newer clients. Last year, the client filed for bankruptcy protection, and its stockholders sued Carl's accounting firm. After it was discovered that a partner in the firm had taken bribe money to issue a clean report, the stockholders won a significant settlement from the firm. The settlement was so large, in fact, that it caused Carl's firm to become bankrupt. Carl will lose his entire investment in the firm but will not suffer any additional liability for the settlement obligation because he had no involvement in issuing the fraudulent audit report. In contrast, the partner who issued the fraudulent report will not only lose his or her investment in the firm but will also remain personally liable for the portion of the settlement obligation remaining unsatisfied after bankruptcy of the accounting firm.

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[1] In many states, only a limited shield of liability protection is available to partners in LLPs. That is, liability protection is available only against losses attributable to acts committed by other partners. In these states, LLP partners retain full, unlimited personal liability for acts of the partnership (for example, defective performance) or acts of non-partner employees of the partnership. This is a primary reason for the popularity of LLCs, which generally carry a full liability shield for owners against liability for acts committed by others, whether or not they have equity stakes in the company.

A relatively new type of limited partnership, the limited liability limited partnership (LLLP), is available in some states.[2] Unlike the LLP, which is a general partnership that registers in the LLP form, an LLLP is a limited partnership in structure that registers with the state in LLLP form. Therefore, the primary difference between an LLLP and the more familiar LLP is the extent to which the partners participate in management. An LLLP is essentially a limited partnership in which all partners, including the general partner(s), have limited liability. Therefore, unlike an LLP, not all partners in an LLLP can participate in management. All do, however, have limited liability for losses incurred as a result of the actions of other partners.

A final type of entity which can be treated for tax purposes as a partnership is the limited liability company (LLC). An LLC, like an LLP or LLLP, extends liability protection to all partners without requiring that they forfeit their ability to participate in management or act as the firm's representative in dealings with parties outside the partnership. Moreover, LLCs, like general partnerships, can elect to be taxed as either partnerships or corporations (including S corporations). In all states and the District of Columbia, an LLC can exist with only one owner. In contrast, LLPs and LLLPs, like all other partnerships, are required to have two or more partners.[3]

Knowledge check

3. Which is **not** a difference between a limited liability company and a limited liability partnership?
   a. An LLC, unlike an LLP or LLLP, can exist with only one owner.
   b. All members of an LLC have limited liability, without requiring that they forfeit their ability to participate in management.
   c. An LLC has members rather than partners, and does not have a general partner.
   d. An LLC does not have a general partner.

[2] Alabama, Alaska, Arizona, Arkansas, Colorado, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Maryland, Minnesota, Missouri, Montana, Nevada, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Virginia, Washington, Wyoming, and the U.S. Virgin Islands allow firms to organize in the LLLP form. Although LLLPs cannot be formed in California, those formed in other states are recognized in California.

[3] A single-owner LLC will not be taxed as a partnership. It is a *disregarded entity* and will instead be treated as a sole proprietorship, or if owned by a corporation, as a division of the corporation. However, the legal protection afforded to members of an LLC will be available to a single-owner LLC as well, allowing the sole proprietor to receive limited liability protection similar to that of a corporate shareholder without paying corporate income tax.

Example 1-4

Bonnie and Roy started a delivery service last year, which they organized as a limited liability company. This year, one of their drivers was driving recklessly and caused an accident. Although the company can be sued, and all its assets forfeited in the resulting lawsuit, Bonnie and Roy's personal assets will be protected because they were not personally involved in the accident. Therefore, like limited partners (or corporate shareholders), the couple's risk of loss is limited to their net investment in the company. Assets held outside the company are not subject to claims against the company.

Knowledge check

4. What is the difference between a limited partnership and a limited liability limited partnership?
    a. Limited partners in a limited partnership do not participate in management, whereas those in a limited liability limited partnership do.
    b. General partners in a limited liability limited partnership have limited personal liability.
    c. All the partners in a limited liability limited partnership have more protection from the liabilities of the partnership than in a limited partnership.
    d. Limited partners in a limited liability limited partnership have limited personal liability.

Layers of taxation

From a tax perspective, the primary benefit of forming as a partnership (or an LLC treated as a partnership) rather than a corporation is that partnership income is subject to only one layer of taxation at the federal level.[4] Partnership income is allocated to the partners each year and taxed on their returns. It is important to note that partners must pay tax on their shares of partnership income whether or not that income is distributed to them. Indeed, because partnership or LLC income is taxed to the partners or investors as it is earned by the entity, subsequent distributions of that income are tax-free. This scheme is quite unlike the corporate tax system in which corporate income is taxed at the corporate level, and subsequent distributions of that income are taxed again to the shareholders as dividend income.

[4] An LLC is taxed as a partnership at the federal level unless an election is made to be taxed as a corporation. How the entity is taxed at the state level will depend upon the state(s) in which it is operating.

Example 1-5

Dawn is a one-half partner in Sunrise Partnership. This year, the partnership reported taxable income of $100,000, of which Dawn's share was $50,000. The partnership made monthly distributions to Dawn of $2,000 ($24,000 total). When Dawn files her individual tax return for the current year, she will include her $50,000 share of the partnership's income (on Schedule E of her Form 1040). The distributions will not affect her taxable income. Therefore, her involvement with the partnership will increase her taxable income by her full $50,000 share of partnership income, even though only $24,000 of this income was distributed to her during the year. In effect, the remaining $26,000 of undistributed taxable income has been reinvested by Dawn in the partnership's business activities.

Losses also flow through to the partners and can be deducted by them on their own tax returns. Again, this is a departure from the corporate tax scheme, in which losses can be carried forward to offset future corporate income but provide no tax benefits until actually offset against positive corporate taxable income. In contrast, partnership losses are reported by the partners on their own tax returns, and if deductible, provide immediate tax benefits in the form of a reduced tax burden on the partners' other income in the year of the loss.

Example 1-6

Robert is an attorney with current-year income from his law practice of $175,000. In addition, he owns a 25% general partnership interest in an oil and gas partnership. The oil and gas partnership drilled a number of dry holes this year and reported a net taxable loss of ($200,000). Robert's one-fourth share of this loss is ($50,000). Assuming his share of the loss is fully deductible, and that he is in the 35% tax bracket this year, the loss will reduce his current-year tax liability by $17,500 ($50,000 × 0.35). He does not have to carry the loss forward to be offset against partnership income which may be reported in a future year. Rather, he can deduct the loss this year against his other business or personal income. As a result, he receives the full benefit of the partnership loss in the current year, when the loss was actually incurred.

Flexibility

Another important advantage of the partnership and LLC form of business is its flexibility. Unlike the corporate form of organization, in which each share of stock (within classes) must provide for its owner an identical interest in the corporation's assets and income, investors in a partnership or LLC can share in entity assets, or entity income, in any way they see fit. Investors' interests in different partnership assets or activities may differ, and these differences may change from one year to the next.

Example 1-7

J, D, and R are individual general partners in an oil and gas drilling partnership. The partners each own one-third of the first well drilled by the partnership, which was successful. However, when D and R wanted to invest a portion of the income from well 1 to drill an additional well on an adjacent property, J opted not to participate. As a result, he or she has no interest in the second well, or in any income generated by that well. That is, J has a one-third interest in the first well and zero interest in the second one. D and R each have one-third interests in the first well, and one-half interests in the second well. If the partners decide to drill a third well, they may have still different interests in that well. They might even decide to bring in another partner to the partnership to participate in drilling the third well, and the new partner may or may not be allowed to share in the profits associated with the first two wells. Each partner's share of partnership profit or loss in each property will be governed by the partnership agreement signed by all the partners. This agreement can be changed with the consent of the partners, and the sharing ratios of the partners can be revised after the fact. This degree of flexibility would be very difficult to obtain if the company had been organized as a corporation and would not be possible at all if the corporation opted to be taxed as an S corporation.[5]

Similarly, a partnership or an LLC may allow its investors to share differently in the risks and rewards of entity operations. Investors with varying tastes for risk may be willing to assume a greater portion of the risk of losses, while sharing profits in accordance with their contributions to capital. One partner, for example, may be willing to be allocated 50% of partnership losses, while sharing in only 33% of partnership profits. Partnerships or LLCs offer complete flexibility to the partners to enter into these kinds of arrangements. The result is that it is often easier to bring investors with different backgrounds together into a partnership or LLC than in other forms of organization.

[5] By law, an S corporation can have only one class of stock and each share of that stock must have an equal interest to all the other shares in every item of S corporation income, loss, credit, and the like. Section 1361(b)(1)(D).

Example 1-8

Lynn owns a large tract of ranch land that she would like to develop into a dude ranch. Unfortunately, she does not have sufficient cash resources to develop the property herself, and she cannot obtain bank financing with favorable terms. She decides to approach the owner of a dude ranch in another state whom she met while on vacation last year. The other ranch owner is interested but is a little wary about investing in an area with which he is unfamiliar. Lynn, however, is confident that a dude ranch on her property would be successful. She is so confident that the venture will succeed that she offers to bear 75% of the risk of loss, while taking only 50% of the profits from the venture, if the other partner will invest the $250,000 needed for improvements to make the dude ranch operable. Assume the other partner makes the necessary investment, and that the dude ranch loses ($50,000) in its first year of operations. Lynn will be allocated 75% of this loss, or ($37,500). Her partner will bear only ($12,500) of the loss. If the dude ranch turns around in its second year, and generates taxable income of $40,000, Lynn's share of the second-year profit will be $20,000 (50%). Therefore, although the partnership's net profit or loss for the two-year period is ($10,000), Lynn has been allocated a loss of ($17,500) [$37,500 - $20,000], whereas her partner has been allocated profits of $7,500 [$20,000 second-year profit less ($12,500) first-year loss]. Lynn is indeed assuming a much larger portion of the risk of loss from their joint activities than is her partner. This disparity may, however, be worthwhile if Lynn is right and the dude ranch develops into a profitable enterprise.

Finally, note that it is possible in a partnership or an LLC to share differently in profits and losses from one year to the next. For example, it is not unusual for a partner to receive a disproportionate share of partnership profits until he or she receives a pre-determined amount, and for profits to be shared equally after that point. To illustrate, in the preceding example, the partners might write the partnership agreement to provide that Lynn's partner will receive 60% of profits until he has recouped his $250,000 investment in the venture, with profits realized after that point being shared equally. Again, this type of flexibility is extremely difficult to achieve in any other form of organization.

Electing to be taxed as a partnership: The “check-the-box” rules

Prior to 1997, entities had to satisfy the cumbersome and highly complex requirements of Reg. Sec. 301.7701 to be classified as partnerships for federal income tax purposes. These regulations required that the entity could not be taxed as a partnership if it possessed more than two of a list of four so-called “corporate” characteristics (limited liability, unlimited life, free transferability of interests, and centralized management).[6] However, the criteria were rendered largely meaningless by the numerous exceptions and limitations imposed in the regulations, so that entities that truly wished to be taxed as partnerships could write their partnership agreements in such a way that partnership status was virtually guaranteed. The result was that the regulations served principally as a trap for the unwary.

To simplify the classification process, and to eliminate the potential that taxpayers who thought they were operating as legitimate partnerships would be subjected to onerous penalties upon discovering that they did not satisfy the technical criteria of the regulations, the IRS in 1996 implemented new rules under which eligible entities will be classified as partnerships unless they file Form 8832, *Entity Classification Election*, and elect to be classified as a corporation or different type of entity.[7] These rules remove any uncertainty about the classification process, and are particularly helpful for limited liability companies, which may freely choose between being taxed as either partnerships or corporations (including S corporations). Uncertainty is further reduced by Reg. Sec. 301.7701-3(b)(1)(i), which provides that in the event an entity neglects to properly file an election, the default classification for domestic entities with at least two members is a partnership. Such entities will automatically be treated as partnerships for federal income tax purposes unless they elect to be classified as a different type of entity.[8] Further reducing uncertainty is the rule that any entity that is incorporated under state law is treated as a corporation for tax purposes. If that entity wants some of the benefits of having its income pass through to the shareholders, it can elect S corporation status.

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[6] The regulations actually identified six corporate characteristics: two or more associates, profit motive, free transferability of interests, limited liability, unlimited life, and centralized management. However, the regulations noted that the first two of these characteristics (associates and profit motive) were common to both partnerships and corporations, and so based the classification criteria on the remaining four characteristics. If the entity possessed more than two of these four remaining characteristics, it was classified as a corporation for federal income tax purposes.

[7] Note that certain *publicly traded* partnerships are classified as corporations for federal income tax purposes, regardless of their preference under the check-the-box rules. A publicly traded partnership is one which conducts an active trade or business and the shares of which are traded on an established securities market or a secondary market. See IRC Section 7704 of the Internal Revenue Code and the Treasury Regulations thereunder.

[8] In some cases, an entity which technically constitutes a partnership may desire not to be recognized as such for federal income tax purposes. Reg. Sec. 1.761-2 provides that such entities can elect not to be taxed as partnerships (and therefore avoid having to file a partnership tax return) if they are formed for investment purposes (rather than to conduct joint business activities) or for the joint production, extraction or use of property, but for the purposes of selling services or property produced or extracted.

Moreover, the regulations provide that the entity choice election is not permanent. Once an entity elects its tax status, it retains such status so long as it does not make an election to change to a different status. Revised status generally cannot be elected during the 60-month period following the previous election, although the commissioner is authorized to permit a change in status if more than 50% of the ownership interests in the entity as of the effective date of the subsequent election are owned by persons that did not own any interests in the entity on the filing date or on the effective date of the entity's prior election.

Therefore, an LLC can elect to be taxed as a partnership for the first five years of its life and then change its status to a corporation for federal income tax purposes thereafter. It is important to recognize, however, that a change in status will not necessarily be tax free. The regulations treat the election to change an entity's status as a liquidation of the old entity accompanied by the formation of a new one.[9] In the case of a partnership electing to be taxed as a corporation, the regulations treat the partnership as if it transferred all its assets and liabilities to a newly formed corporation (requiring a new taxpayer identification number) in exchange for stock, and then liquidated, distributing the corporate stock to its partners. Because liquidation of a partnership is generally a tax-free transaction, this deemed transaction will seldom have any tax consequences for the members.[10]

Example 1-9

L is a 50% partner in the LT Partnership. L's tax basis in his partnership interest was $200,000 when the partnership opted to be classified as a corporation and made the election to be taxed under subchapter S. (The partners hoped to reduce their self-employment tax liability by making this change in status.) To accomplish the conversion to a regular corporation, the partnership transferred all its assets to a newly formed corporation in exchange for stock. Assume that the partnership had no liabilities at the date of the conversion. The partnership then liquidated, distributing the newly acquired stock to its partners in liquidation of their interests in the partnership. L received stock with a tax basis to the partnership of $350,000 and a fair market value of $425,000 in liquidation of his interest in the LT Partnership. L will recognize no gain or loss on the transaction and will take a tax basis in his stock in the new corporation of $200,000.

[9] See Reg. Sec. 301.7701-3(g).

[10] One important exception will apply where one or more partners have a deficit balance in their capital accounts as of the date of the deemed liquidation of the partnership. Partners with deficit capital balances will be required to make contributions to the partnership to restore their capital balances to $0. Forgiveness of this obligation by the entity will likely result in cancellation of debt income to such partners.

In contrast, where the entity has been operating as a corporation, the election to change its status to a partnership is treated under the regulations as if the corporation first liquidates, distributing all its assets and liabilities to its shareholders, who then transfer these assets and liabilities to a new partnership (again requiring a new taxpayer identification number) in exchange for interests in the partnership. Because corporate liquidations are generally fully taxable to both the corporation and its shareholders,[11] the election to change status from a corporation to a partnership may have significant tax consequences.

Example 1-10

Q and R each own 50% of the shares of Pheasant Ridge, LLC, formed four years ago. Following its formation, the company elected to be taxed as a corporation. Q and R each have tax bases of $120,000 in their LLC interests. The company owns assets with an aggregate tax basis of $250,000 and an aggregate value of $350,000. It has no liabilities. Effective January 1 of the current year, Pheasant Ridge, LLC filed Form 8832 electing to change its status from a corporation to a partnership for federal tax purposes.

Pheasant Ridge will be deemed to liquidate on January 1 of the current year, distributing its assets to Q and R equally. This deemed distribution to Q and R is taxable to Pheasant Ridge as if it had sold its assets for their fair market values and distributed the proceeds to its shareholders. Accordingly, the LLC will recognize a $100,000 gain on the deemed sale and will owe federal income tax of $21,000 on its final income tax return. (The company has no other income in the year of liquidation, as it liquidated on January 1.)

Q and R will also recognize taxable gain on the deemed liquidation. They will be deemed to have received a net distribution of $329,000 ($350,000 FMV of assets, less $21,000 tax liability to the federal government) in exchange for their shares in Pheasant Ridge. Their combined tax basis in these shares is $240,000 ($120,000 each). Therefore, they must recognize a combined gain of $89,000 ($44,500 each). Because they have held their shares for four years, the gain will be taxed as a long-term capital gain, subject to a maximum tax rate of 20%, plus a possible additional 3.8%, depending on the taxable income of the partners. Assuming they have no capital losses and their tax rate on long-term capital gains is 20%, they will each owe $8,900 in additional income taxes on the capital gains. Therefore, the combined tax cost of changing the LLC's federal tax status from a corporation to a partnership will be $38,800 ($21,000 corporate tax, plus $8,900 tax to Q, plus $8,900 tax to R).

The election to change tax status should clearly not be made without full consideration of the potential costs and consequences.

Practical insight: Typically, a practitioner and a taxpayer would not be inclined to incur the federal income tax cost associated with the liquidation of a corporation so that the business form could be switched to a partnership form unless some other significant non-tax business purpose existed.

[11] See IRC Sections 311(b) and 331.

Overview of the basic framework of partnership taxation

The partnership tax framework allows partners and partnerships wide latitude in structuring their companies and in dealing with one another. Formation of a partnership, like formation of a corporation, is generally a tax-free transaction. Indeed, the rules governing partnership formation are even more lenient than those governing corporate formation, in that there is no requirement that contributing partners have "control" of the partnership in order for the transaction to be tax-free. Also, like corporate formations, the partners' bases in assets contributed to the partnership carry over to the partnership (that is, the partnership takes a "carryover" basis in contributed properties), and the partners' initial bases in their partnership interest is generally equal to the basis of cash and other property contributed to the partnership in exchange for that interest. (However, a partner's basis in his partnership interest is also increased by his share of partnership liabilities, unlike the shareholder or corporation treatment of liabilities.)

A major difference between partnerships and corporations, of course, is that the taxable income of the partnership is taxable to the partners, rather than to the partnership itself. Therefore, the reporting process by which the partnership's taxable income is reported to the IRS, and to its partners, is rather complex. Moreover, the process of accounting for partnership income is more complex in that the partners must account for their shares of partnership income or loss each year, whether or not any distributions of that income are received or additional contributions are made by the partners.

Another major difference between partnerships and corporations is the treatment of distributions to partners. Because the partners are taxed directly on their shares of partnership income, distributions of that income are generally tax-free. Most distributions are treated as decreases in the basis of their partnership interests rather than as taxable income. To ensure that the distribution to a partner of his or her share of partnership income does not inadvertently trigger recognition of taxable gain, partners are required to adjust their bases in their partnership interests to reflect their shares of the partnership's income or loss each year. The result of these basis adjustments is that a partner will generally have sufficient basis to absorb a subsequent distribution of his or her share of partnership profit without triggering gain recognition.

Example 1-11

Arthur contributed property with a tax basis of $100,000 and a fair market value of $500,000 to the newly formed AY Partnership this year in exchange for a 50% interest therein. For its first year, the partnership reported taxable income of $600,000, of which Arthur's share was $300,000. The partnership distributed half its income to the partners and reinvested the other half in its operations. Therefore, Arthur received a distribution of $150,000. Absent an adjustment to his basis in his partnership interest to reflect his $300,000 share of the partnership's income, the distribution to Arthur of $150,000 of his share of partnership profits would trigger recognition of a $50,000 taxable gain. (His initial tax basis in the partnership interest was only $100,000, which would not be sufficient to absorb a $150,000 distribution).

However, because Arthur's tax basis in his partnership interest is increased by his $300,000 share of partnership income (to $400,000), the $150,000 distribution will be tax-free. His remaining tax basis in the partnership interest will be $250,000 ($400,000 - $150,000). Looked at another way, his basis in the partnership interest was increased by the $150,000 share of partnership profits which he did not withdraw from the partnership. By not withdrawing this portion of his share of profits, he essentially contributed those profits back to the partnership. His basis in the partnership interest is increased accordingly.

Note that one result of the preceding framework is that the partners' aggregate bases in their partnership interests (outside basis) generally equal the partnership's aggregate bases in its assets (inside basis). This equality is important because it prevents taxpayers from using partnerships to manipulate the tax consequences associated with the sale or other disposition of property. Because the partners' outside bases in their partnership interests generally equal the partnership's aggregate inside basis in its assets, the same amount of gain or loss is recognized when a partner sells his or her interest in a partnership as would have been recognized if he or she had sold the asset(s) contributed to the partnership in exchange for that interest. Likewise, the partnership will recognize the same amount of gain or loss from the sale of its assets as the partners who contributed those assets would have recognized had they sold them directly, rather than through the partnership.

Example 1-12

Jamie contributed property with a tax basis of $28,000 and a fair-market value of $50,000 to the JQL partnership in exchange for a one-third interest therein. She will recognize no gain or loss on exchange of the property for the partnership interest. Her basis in her partnership interest is $28,000, and the partnership takes a $28,000 basis in the property contributed by Jamie. Assuming that Jamie subsequently decides to sell her interest in the partnership for its $50,000 value, she will recognize a taxable gain of $22,000. This is the same amount of gain she would have recognized had she sold the property rather than contributing it to the partnership. Likewise, if the partnership sells the property contributed by Jamie for its $50,000 fair market value, it will also recognize a $22,000 gain. Therefore, transfer of the property to the partnership does not change the tax consequences associated with a later sale of the property or of the partnership interest received in exchange for the property.

Partnership operations

Measuring and reporting partnership income

Although partnership income is taxed at the partner level, it must be measured and reported by the partnership. The partnership files an annual tax return, Form 1065, with the IRS. Attached to the return is a Schedule K-1 for each partner in the partnership, reporting that partner's share of each item of partnership income or loss. Two copies of each Schedule K-1 are filed—one with the IRS and one with the partner. The K-1 identifies the partner, his or her social security number (or other identification number), and his or her address, along with such partner's share of partnership items of income, loss, gain, deduction and other information (for example, alternative minimum tax preferences, and the like). The partners then include their shares of each item of partnership taxable income, as reported to them on Schedule K-1, on their individual tax returns. They pay tax on their shares of partnership taxable income whether or not those shares are distributed to them during the year.

The computation of partnership taxable income is complicated by the need to ensure that all items of partnership income are treated the same on the partners' returns as if those items had been earned or incurred by the partners directly rather than through the partnership. For example, for individuals, the deduction for net capital losses is limited to $3,000 per year. This limitation applies both to net capital losses incurred directly and those incurred by partnerships and allocated to the individual partners.

Example 1-13

Lucy and Ethel are equal 50% partners in the LE Partnership. This year, Lucy incurred net capital losses of ($2,000) from the sale of stock (outside the partnership). Ethel realized a net capital gain of $4,500. In addition, the LE Partnership incurred a net capital loss of ($10,000). Lucy's share of this loss is ($5,000), as is Ethel's. On their individual tax returns, however, Lucy will be able to deduct only ($1,000) of her share of this loss because she already had ($2,000) of net capital losses before considering her share of the partnership loss. Individuals are not allowed to carry net capital losses back but may carry them forward indefinitely. Therefore, Lucy will carry the remaining ($4,000) net capital loss forward to next year. Ethel, on the other hand, can deduct her entire ($5,000) share of the partnership's net capital loss. When added to her net capital gains of $4,500 generated outside the partnership, Ethel's total net capital loss is only ($500), well within the ($3,000) annual limit.

There are many items of income, gain, loss, or deduction that may be subject to similar limitations or special treatment on the partners' individual tax returns. For example, charitable contributions are subject to limitations on the returns of individuals and corporations. Similarly, the Section 179 deduction available to individuals is subject to annual limitations. Losses from rental real estate are subject to the passive loss rules. To allow these limitations to be applied properly on the partners' tax returns, each partner's share of these items must be reported separately from other partnership taxable income.

Knowledge check

5. J.D. Rackmore received a Schedule K-1 from a partnership reporting the following items of income, gain, loss, and deduction for the current year:

Share of partnership ordinary income	$ 4,500
Capital gains (net)	1,500
Interest income	700
Charitable contributions	(1,000)

J.D., who does not itemize deductions, has no other investments in partnerships or other pass-through entities. By how much will her investment in this partnership increase her taxable income for the current year?

a. $4,500.
b. $6,000.
c. $6,700.
d. $5,700.

Other items may allow the partners to use a greater portion of expenses or losses incurred outside the partnership when preparing their tax returns. A partner with capital losses outside the partnership, for example, may be allowed to deduct some or all of these losses against his or her share of partnership capital gains. Partners with "excess" investment interest expense may be able to deduct some of this interest against investment income allocated from the partnership. Passive losses incurred outside the partnership may be deductible against passive income reported by the partnership. For corporate partners (that is, partners who are corporations), the dividends-received deduction may be increased by a portion of dividends received through the partnership.

Reflecting the numerous special provisions which must be considered when preparing the partners' individual tax returns, partnership income is reported to the partners in pieces, rather than as a single number labeled "partnership taxable income." In essence, the partnership's taxable income is reported in three parts. The front page of Form 1065 reports those items of income and deduction that are not subject to special treatment on any partner's tax return. These items result in net partnership "ordinary business income (loss)." Note that although all of the items that make up partnership ordinary business income are ordinary (otherwise they would be subject to special treatment by the partners), there are some ordinary income items, such as interest income, which are specially treated and therefore not included in partnership "ordinary business income." On page 4 of Form 1065 is Schedule K, which reports to the IRS both net partnership ordinary business income or loss (from page 1 of Form 1065), and the totals of each item of income, gain, loss, deduction, credit, and the like, which may be subject to special treatment on one or more of the partners' tax returns. Therefore, the partnership's actual total net income or loss is derived from Schedule K, rather than from page 1 of the Form 1065.

Finally, each line item on Schedule K is divided among the partners and reported to those partners on Schedule K-1s. Each partner receives a copy of his or her Schedule K-1 (an additional copy is attached to partnership tax return filed with the IRS) reporting his or her share of each of these items (net ordinary business income and each other item which may be subject to special treatment). From the K-1, each partner then determines how partnership activities affect his or her individual taxable income.

Example 1-14

The JD Partnership reported the following items of income, gain, loss, and deduction for the current year:

Sales	$450,000
Cost of goods sold	(150,000)
Gross profit	$300,000
Long-term capital gains (net)	15,000
Interest income	7,000
Salaries paid to employees	(50,000)
Depreciation expense	(25,000)
Taxes (payroll and property taxes paid to the state)	(18,000)
Charitable contributions	(10,000)

J and D are each 50% partners. The partnership will report ordinary business income of $207,000 ($300,000 – 50,000 – 25,000 – 18,000) on page 1 of Form 1065. This amount will be carried to Schedule K (line 1), which will also report, on separate lines, the partnership's long-term capital gains of $15,000, interest income of $7,000 and charitable contributions of ($10,000). Each of the partners will receive a Schedule K-1 (see the appendix to this course for a sample) showing his or her $103,500 share of partnership ordinary income, $7,500 share of partnership long-term capital gain, $3,500 share of partnership interest income and ($5,000) share of partnership charitable contributions. This result is illustrated in the following table:

Description	Form 1065, p.1	Schedule K	Schedule K-1, J	Schedule K-1, D
Net ordinary business income	$207,000	$207,000	$103,500	$103,500
Separately stated items:				
Long-term capital gains		15,000	7,500	7,500
Interest income		7,000	3,500	3,500
Charitable contributions		10,000	5,000	5,000
Analysis of net income (Loss)			$219,000	

Example 1-15

Consider the facts of example 1-14. Assume partner J incurred net capital losses outside the partnership of ($5,500) and had net investment interest expense (in excess of investment income) of ($2,000). D, the other partner, had no capital gains or losses outside the partnership, and no investment interest expense. For the current year, J's share of partnership income (and the items thereof) will cause her taxable income to increase by $102,000 ($103,500 ordinary income, plus $7,500 long-term capital gain, plus $3,500 interest income, less ($5,000) charitable contributions, less additional capital loss deduction of ($5,500) and additional investment interest expense deduction of ($2,000)). D's share of partnership items, in contrast, will increase her current year taxable income by $109,500 ($103,500 + $7,500 + $3,500 – $5,000). Having no capital losses or excess investment interest expense outside the partnership, her share of partnership items does not increase her other deductions as it did for J.

Effect on the partners: Basis

Partners are taxable on their shares of partnership income whether or not that income is distributed to them. Where some or all of a partner's share of partnership income is not distributed (that is, is retained by the partnership) the excess represents an additional investment by the partner in the partnership. Accordingly, under Section 705(a)(1), a partner's share of items of partnership income, including nontaxable income (for example, municipal bond interest) increases his or her basis in the partnership interest. Basis is then reduced by the portion, if any, of that income which is distributed to the partner during the year.

Example 1-16

Elaine and Jerry formed a partnership early last year to purchase rental properties. They each contributed $25,000 to the partnership, which then borrowed $150,000 on a recourse loan, and purchased rental real estate. Each partner's initial basis in the partnership interest was therefore $100,000 ($25,000 contributed plus $75,000 share of debt). In its first year, the partnership reported net income of $30,000, and made distributions to Elaine and Jerry of $8,000 each. Elaine and Jerry will each report $15,000 income on their individual returns (their shares of the partnership's $30,000 income) even though they received only $8,000 in distributions. Their bases in their partnership interests will be $107,000 at year-end ($100,000 initial basis, plus $15,000 share of partnership income, less $8,000 distribution received).

At first glance, it may seem unusual for the partner to be allowed to increase basis in the partnership interest by his or her share of nontaxable income. This basis adjustment, however, is necessary to prevent the tax-exempt income from indirectly becoming taxable when the partner later sells or otherwise disposes of his or her interest in the partnership.The tax-exempt income increases the partnership's net assets, and therefore, presumably, the value of the equity interests in the partnership. An increase in value, without a corresponding increase in basis, would cause more gain to be recognized upon a subsequent sale of the interest.

Example 1-17

Tim is a 20% partner in Sparrowhawk Partners. He contributed $40,000 to the newly-formed partnership in exchange for his interest early this year. The partnership invested all its capital in municipal bonds. For the year, Tim's share of the partnership's municipal bond interest income was $2,000. The partnership had no other items of income or loss. Although this income is not taxable, it increases Tim's share of partnership assets to $42,000. If he were not required to increase his tax basis in the partnership interest by his share of the tax-exempt municipal bond interest, a subsequent sale of that interest for its $42,000 value would trigger a $2,000 taxable gain to Tim. (His initial basis in the partnership interest was $40,000.) The basis adjustment preserves the tax-exempt nature of the income allocated to Tim.

If the partnership reports a loss, rather than a profit, each partner's share of the loss reduces his or her interest in the partnership's remaining partnership assets. Section 705(a)(2) requires that the partner's basis in the partnership interest be reduced by his or her share of each item of partnership loss or expense, including nondeductible losses or expenses. The reason nondeductible expenses reduce the partner's basis in the partnership interest is similar to the reason tax-exempt income increases basis. If a partner's basis was not reduced for nondeductible expenses, the partner would presumably have a greater loss or lower gain on the sale of the partnership, which would be essentially equivalent to making the expenses deductible.

Example 1-18

Dennis is a 10% partner in Dame Partners. At the beginning of the year, his basis in Dame was $25,000. For the year, Dennis received a K-1 from Dame Partners reporting that his share of partnership ordinary income or loss was ($12,000), and his share of partnership interest income was $2,500. Dennis' basis in his partnership interest at the end of the year will be $15,500 ($25,000 - $12,000 + $2,500).

In summary, partners include their shares of each item of partnership income, gain, loss, or deduction on their own tax returns each year, whether distributed to them or not. A partner's basis in his or her partnership interest is adjusted upward by his or her share of items of partnership income or gain. It is adjusted downward for his or her share of items of partnership loss or deduction. Finally, as the partner withdraws his or her share of partnership income, or portions thereof, basis is adjusted downward to reflect the distributions. In this way, the partner's basis in the partnership interest reflects the partner's net investment, direct and indirect, in the partnership.

Effect on the partners: Rights to partnership assets

A partner's share of partnership income or loss usually affects his or her rights to partnership assets. For example, if a partner contributes $12,000 to a partnership, and is allocated a $10,000 share of partnership income in the first year, he or she has a claim to $22,000 of the partnership's assets. If the partner receives no distributions in the current year, he or she expects to receive at least $22,000 in the future. Likewise, if the partner's share of partnership income or loss had been a ($2,000) loss, he or she would have a remaining claim against partnership assets of only $10,000 (the original $12,000 contribution, less the ($2,000) share of the partnership's operating loss). Note that the partner's claim against the partnership's assets is not the same as the partner's basis in his or her partnership interest. One reason these amounts differ is that the latter includes the amount the partner might have to pay should the partnership fail (that is, the partner's share of partnership liabilities).

The partner's share of the partnership's basis in partnership assets is called the *inside basis.* The partner's basis in the partnership interest, which includes the share of partnership liabilities, is referred to as the *outside basis.*

The partners' contributions to the partnership, and their rights to partnership assets, are reflected in the capital section of the partnership's balance sheets. For tax purposes the partnership maintains two sets of books and records. The first set reflects the partnership's tax basis in its assets and is used to determine the tax consequences of its transactions. The second set of records reflects the book value of the partnership's assets and is used to determine the economic consequences of partnership transactions.[12]

Example 1-19

Dale and Roy formed a partnership early this year. Dale contributed $100,000 cash in exchange for a 50% interest in the partnership. Roy contributed land with a tax basis of $60,000 and a fair market value of $100,000 in exchange for the remaining 50% interest in the partnership. The partnership will establish two sets of books and records. The first will record the land contributed by Roy at its $60,000 tax basis (which becomes the partnership's tax basis in the property under Section 723), along with the $100,000 cash contribution by Dale. In addition, this balance sheet will record Dale's capital contribution at $100,000, and Roy's at $60,000. The second set of records maintained by the partnership will reflect the book values of the two partnership assets, as well as Dale's and Roy's relative interests in those assets. On this set of books, the land will be recorded at its date of contribution value of $100,000, as will the cash. Dale's and Roy's capital accounts will each be $100,000. Therefore, the partnership's initial balance sheets will be as follows (amounts in thousands):

[12] Many partnerships also maintain a set of GAAP books and records, which may differ from the "book" records required under Section 704(b).

Example 1-19 (continued)

	Section 704(b)		
	Tax	Book	GAAP*
Cash	$100	$100	$100
Land	60	100	100
Total Assets	$160	$200	$200
Capital, Dale	$100	$100	$100
Capital, Roy	60	100	100
Total Liabilities and Capital	$160	$200	$200

Interpretation of the balance sheets is straightforward. The tax balance sheet indicates that the partnership has an aggregate basis in its assets of $160,000. Dale contributed $100,000 of this, and Roy contributed $60,000. Therefore, Dale stands to lose $100,000, although Roy stands to lose only $60,000, measured in historical cost terms. (Although Roy stands to lose $100,000 economically, $40,000 of this loss would be an opportunity loss.) In contrast, review of the book balance sheet indicates that the partnership has total assets with a market value (at date of contribution) of $200,000, of which $100,000 would go to Roy and $100,000 to Dale upon liquidation.

* The partnership's initial balance sheet, reported on Schedule L of Form 1065 should generally agree with the partnership's books and records, which should be based on generally accepted accounting principles (GAAP). However, as discussed in a subsequent course, there are certain occasions in which the partnership is allowed to "revalue" its book balance sheet for tax purposes. Such revaluations may result in the partnership maintaining three sets of books and records—one accounting for the tax basis of partnership assets, another accounting for the Section 704(b) book value of those assets, and a third accounting for the GAAP book value of those assets.

As illustrated in the previous example, capital accounts are maintained separately for each partner in the partnership. The capital account is increased by net contributions (that is, net of debt) to the partnership, and by the partner's share of partnership net income. It is decreased by net distributions received from the partnership, and by the partner's share of net partnership losses (if any). Therefore, the tax capital accounts summarize the basis of what each partner has invested in the partnership (tax balance sheet). The book capital accounts summarize what each partner is entitled to receive from the partnership at liquidation (book balance sheet).

Example 1-20

Lisa and Bill formed a partnership to purchase an office building. Lisa contributed $50,000 cash to the partnership in exchange for a 50% interest therein. Bill contributed land with a tax basis of $25,000 and a fair market value of $50,000 for the remaining 50% interest. The partnership then borrowed $400,000 and purchased an office building for $450,000. The partnership's balance sheets will look as follows immediately after formation:

		Section 704(b)
	Tax	Book
Land	$25,000	$50,000
Building	450,000	450,000
Total assets	$475,000	$500,000
Mortgage, Building	$400,000	$400,000
Capital, Lisa	50,000	50,000
Capital, Bill	25,000	50,000
Total liabilities & capital	$475,000	$500,000

The initial tax balance sheet indicates that Lisa contributed $50,000 toward the tax basis (remaining cost) of the partnership's assets, and Bill contributed $25,000 of this amount. Yet, as indicated on the book balance sheet, Lisa and Bill would each be entitled to receive $50,000 if the partnership were to liquidate. Now assume that in its first year of operations, the partnership earns net income (book and tax) of $120,000 and distributes $40,000 of this amount to Lisa and Bill ($20,000 each). Assuming no change in debt, the partnership's balance sheets would now have the following balances:

		Section 704(b)
	Tax	Book
Total assets	$555,000	$580,000
Mortgage, Building	$400,000	$400,000
Capital, Lisa	90,000	90,000
Capital, Bill	65,000	90,000
Total liabilities & capital	$555,000	$580,000

Example 1-20 (continued)

As illustrated, Lisa and Bill's capital accounts would each be increased by $40,000 on both balance sheets ($60,000 share of partnership net income, less $20,000 distribution received). Therefore, Lisa's $90,000 capital balance on the tax basis balance sheet reflects her total direct investments in the partnership of $50,000 at formation plus her $40,000 of reinvested profits. Bill's capital account on the tax basis balance sheet reflects the $25,000 basis of the land initially contributed to the partnership, plus $40,000 of reinvested profits. The book balance sheet, in contrast, indicates that if the partnership were to sell all its assets at their $580,000 year-end book value, each partner would receive $90,000, after payment of the partnership's creditors. This balance sheet reflects the partners' legal and economic rights to partnership assets, which are based on the fair market values of the properties each contributed (as of the date of contribution), adjusted for additional investments (reinvested profits) and distributions made since that time.

Therefore, the partner capital accounts play a crucial role in determining the consequences for the partners of partnership activities. Because a partner's share of partnership income is credited to his or her capital account, therefore giving him or her a right to withdrawal of a like amount, he or she is taxable on that income even if it is not currently distributed by the partnership. Any income not withdrawn remains in the partner's capital account, and constitutes an additional investment by the partner in the partnership. The partner's basis in the partnership interest is increased to reflect this additional investment. Finally, because the partner retains the right to withdraw his or her capital, including reinvested earnings, from the partnership in the future, his or her interest in partnership assets, as reflected on the book balance sheet, is also increased by any portion of that share of earnings which is not withdrawn (that is, received as a distribution) in the current year.

Knowledge check

6. Dale and Roy formed a partnership early this year. Dale contributed $150,000 cash in exchange for a 50% interest in the partnership. Roy contributed land with a tax basis of $90,000, and a fair market value of $150,000 in exchange for the remaining 50% interest in the partnership. What will be the balance in Roy's book capital account in the partnership's balance sheet?

    a. $150,000.
    b. $90,000.
    c. $60,000.
    d. $75,000.

Self-employment tax issues

Generally speaking, a significant disadvantage of the partnership form relative to the S corporation form is the self-employment tax. A shareholder's share of pass-through income from an S corporation is generally not treated as earned income,[13] and therefore does not trigger self-employment (SE) taxes; in contrast, a general partner's share of ordinary income (but not capital gains, interest income, and the like) from a partnership is subject to self-employment tax.

Different rules apply to limited partners. Because limited partners are not allowed to participate in management, their shares of partnership income are not classified as earned income and therefore do not trigger self-employment tax.[14] This provision does not apply to guaranteed payments received in exchange for services rendered to or on behalf of the partnership.

For this reason, it is not uncommon for some general partners to structure a portion of their interest in a limited partnership as a limited partnership interest. For example, a partner may own a 1% general partnership interest and a 9% limited partnership interest. This structure does not protect the general partner from personal liability for partnership losses, but does result in the portion of partnership income attributable to the partner's limited partnership interest to be classified as unearned income, not subject to the self-employment tax. As long as the partner is fairly compensated for any services (for example, management services) provided in his or her capacity as a general partner, the IRS should not challenge this arrangement.

Although it is clear how these provisions apply to general and limited partnerships, it is much less clear how they should be applied to limited liability companies. The proposed regulations under Section 1402 attempt to provide some guidance on this question. As a general rule, the proposed regulations treat an investor in an LLC (or any other type of entity) as a limited partner unless such investor

- has *personal liability* for the debts of or claims against the LLC by reason of being a partner or member;
- has authority under state law to contract on behalf of the LLC; or
- participates in the LLC's trade or business for more than 500 hours during the entity's taxable year.[15]

The proposed regulations establish two exceptions to these rules. First, no individual who is a *service partner* in a service partnership (including an LLC electing to be taxed as a partnership) can be classified as a limited partner. Therefore, members of LLCs engaged in the practice of health, law, engineering, architecture, accounting, actuarial science, or consulting will generally not be treated as limited partners (and therefore will be subject to SE taxes) unless they provide no services to or on behalf of the LLC.[16]

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[13] Note, however, that if the shareholder does not withdraw a reasonable salary as compensation for any services rendered on behalf of the S corporation, some or all of his or her pass-through income may be reclassified as wages or salary income.

[14] Section 1402(a)(13).

[15] Proposed Reg. Sec. 1.1402(a)-2(h)(2), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

[16] Proposed Reg. Sec. 1.1402(a)-2(h)(5) and (6)(iii), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

Second, the proposed regulations provide that a member of an LLC can be treated as a limited partner even if he or she participates in the LLC's trade or business for more than 500 hours if

- the member would be treated as a limited partner if not for his or her participation in the LLC's trade or business for more than 500 hours;
- other members who are treated as limited partners own a substantial continuing interest in the LLC; and
- such other members have rights and obligations with respect to their membership interests in the LLC that are identical to those of the member participating in the LLC's activity for more than 500 hours during the taxable year.[17]

Note that Proposed Reg. Sec. 1.1402(a)-2(h) have expired and to date the IRS has not issued new regulations regarding the classification of investors in LLCs. However, the expired regulations do give us some guidance regarding the IRS opinion in these matters.

Example 1-21

A, B, and C are members of an LLC that has elected to be taxed as a partnership for federal income tax purposes. The LLC is not a service partnership as defined in the proposed regulations under Section 1402. A and B each own one unit in the LLC; C owns two units. Therefore, A and B are each entitled to share in 25% of the company's profits and losses, but C receives 50%. In addition, B and C perform services on behalf of the LLC. B worked 600 hours in the current year, but C worked 1,000 hours. C, as the managing "partner" of the LLC, has the authority under state law to contract on the LLC's behalf. B and C each received guaranteed payments from the LLC as compensation for services rendered. None of the members has personal liability for entity debts or claims against the entity.

The proposed regulations provide that A, who is not authorized to contract on behalf of the LLC, does not provide services to or on behalf of the LLC, and has no personal responsibility for LLC debts, will be treated as a limited partner. Therefore, his or her distributive share of LLC ordinary income will be excluded from his or her net earnings from self-employment.

Likewise, B will also be classified as a limited partner. Although B performed more than 500 hours of service for the LLC, he or she is not authorized to contract on the LLC's behalf and is not personally liable for LLC debts. Moreover, his or her rights and obligations as a member of the LLC are identical to A's. Because A's interest in the LLC is substantial, and A is treated as a limited partner, B will also be treated as a limited partner. His or her distributive share of LLC income will not be subject to SE tax, although the amounts received as guaranteed payments for services rendered to the LLC will be subject to SE tax.

Unlike A and B, C will not be treated as a limited partner, because he or she has the authority to contract on behalf of the LLC. Accordingly, both his or her distributive share of LLC ordinary income and any amounts received as guaranteed payments for services rendered to the LLC will be classified as earned income.[18]

[17] Proposed Reg. Sec. 1.1402(a)-2(h)(4), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

[18] Proposed Reg. Sec. 1.1402(a)-2(i) Example (i), issued January 13, 1997, and not yet replaced by permanent regulations as of the date of this publication.

These rules appear to be consistent with proposed regulations under IRC Section 469 issued in November 2012. Proposed Reg. Sec. 1.469-5(e)(3)(i) change the rules for determining whether an LLC member should be treated as a limited partner for purposes of the passive loss limitations. Unlike the existing regulations under IRC Section 469, which base the determination of limited partnership status on the issue of whether the partner or LLC member enjoys limited liability for the entity's activities, the proposed regulations base this determination instead on the LLC member's right to "manage" the entity.[19] Presumably, an LLC member should be classified consistently regardless of the statute under which his or her status is being evaluated. Therefore, a member of an LLC who does not have the right to participate in management is properly classified as a limited partner whose allocable share of LLC losses will be subject to the passive loss limitations of IRC Section 469, but whose allocable share of profits will not be subject to self-employment taxes. In contrast, if the member does have the right to participate in management (whether or not exercised), his or her allocable share of LLC losses will not be subject to the passive loss limitations and any allocable share of LLC profits will be subject to SE taxes.

[19] Proposed Reg. Sec. 1.469-5(e)(3)(i)(B).