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Partnerships

For use in preparing
1996 Returns

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Important Reminders

Self-employed health insurance deduction. The deduction for health insurance costs for self-employed persons has been permanently extended. The deduction is 30% for 1996. For more information, see *Self-employed health insurance premiums* under *Guaranteed Payments*, later.

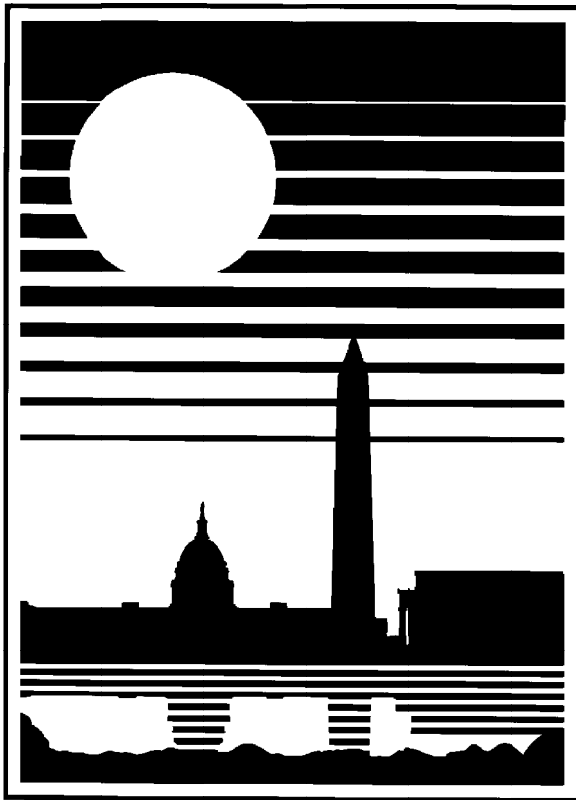
Distribution of marketable securities. A distribution of marketable securities made to a partner after December 8, 1994, is treated as money in determining whether gain is recognized by the partner on the distribution. See *Partnership Distributions*, later.

Introduction

This publication explains how the tax law applies to partnerships and to partners. A partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include partnership items on their tax returns.

For a discussion of business expenses a partnership can deduct, see Publication 535. Members of oil and gas partnerships should read about the deduction for depletion in chapter 13 of that publication.

Certain partnerships must have a tax matters partner (TMP) who is also a general partner. For information on the rules for designating a TMP, see the instructions for Schedule B of Form 1065 and Temporary Regulations section 301.6231(a)(7)-1T.



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Withholding on foreign partner or firm. If a partnership acquires a U.S. real property interest from a foreign person or firm, the partnership may have to withhold tax on the amount it pays for the property (including cash, fair market value of other property, and any assumed liability). If a partnership has income effectively connected with a trade or business in the United States, it may have to withhold on the income allocable to its foreign partners. A partnership **must** withhold tax on a foreign partner's distributive share of fixed or determinable income not effectively connected with a U.S. trade or business. A partnership that fails to withhold may be held liable for the tax, applicable penalties, and interest. For more information, see Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Corporations*.

Useful Items

You may want to see:

Publication

- 505** Tax Withholding and Estimated Tax
- 533** Self-Employment Tax
- 535** Business Expenses
- 537** Installment Sales
- 538** Accounting Periods and Methods
- 544** Sales and Other Dispositions of Assets
- 551** Basis of Assets
- 556** Examination of Returns, Appeal Rights, and Claims for Refund
- 925** Passive Activity and At-Risk Rules
- 946** How To Depreciate Property

Form (and Instructions)

- 1065** U.S. Partnership Return of Income
- Schedule K-1 (Form 1065)** Partner's Share of Income, Credits, Deductions, Etc.
- 1128** Application to Adopt, Change, or Retain a Tax Year
- 3115** Application for Change in Accounting Method
- 4562** Depreciation and Amortization
- 8308** Report of a Sale or Exchange of Certain Partnership Interests
- 8582** Passive Activity Loss Limitations
- 8736** Application for Automatic Extension of Time To File U.S. Return for a Partnership, REMIC, or for Certain Trusts

See *How To Get More Information* near the end of this publication for information about getting these publications and forms.

Forming a Partnership

A partnership is the relationship between two or more persons who join together to carry on a trade or business. Each person contributes

money, property, labor, or skill, and each expects to share in the profits and losses. "Person," when used to describe a partner, means an individual, a corporation, a trust, an estate, or another partnership.

For federal income tax purposes, the term "partnership" includes a syndicate, group, pool, joint venture, or similar organization carrying on a trade or business and is not classified as a trust, estate, or corporation.

A joint undertaking merely to share expenses is **not** a partnership. Mere co-ownership of property maintained and leased or rented is **not** a partnership. However, if the co-owners provide services to the tenants, a partnership exists.

Limited Liability Company (LLC)

An LLC is an entity formed under state law by filing articles of organization as an LLC. Unlike the partners in a partnership, none of the members of an LLC are personally liable for its debts. An LLC can be classified as either a partnership or a corporation for federal income tax purposes. It is classified as a partnership if it has no more than two of the following corporate characteristics:

- 1) Centralization of management.
- 2) Continuity of life.
- 3) Free transferability of interests.
- 4) Limited liability.

If an LLC is treated as a partnership, it must follow the rules explained in this publication.

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

The same rules apply if an LLC classified as a partnership is converted into a partnership.

Family Partnership

Members of a family can be partners. However, family members (or any other person) will be recognized as partners only if one of the following requirements is met.

- 1) If capital is a material income-producing factor, they acquired their capital interest in a bona fide transaction (even if by gift or purchase from another family member), actually own the partnership interest, and actually control the interest.
- 2) If capital is not a material income-producing factor, they must have joined together in good faith to conduct a business. In addition, they must have agreed that contributions of each entitle them to a share in the profits. Some capital or service must be provided by each partner.

Capital is material. Capital is a material income-producing factor if a substantial part of the gross income of the business comes from the use of capital. Capital is ordinarily an income-producing factor if the operation of the business requires substantial inventories or investments in plants, machinery, or equipment.

Capital is not material. In general, capital is not a material income-producing factor if the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership.

Capital interest. A capital interest in a partnership is an interest in its assets that is distributable to the owner of the interest if:

- 1) He or she withdraws from the partnership, or
- 2) The partnership liquidates.

The mere right to share in earnings and profits is not a capital interest in the partnership.

Gift of capital interest. If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is limited. To figure the donee's share:

- 1) The partnership income must be reduced by reasonable compensation for services the donor renders to the partnership, and
- 2) The donee-partner's share of the remaining profits allocated to donated capital must not be proportionately greater than the donor's share attributable to the donor's capital.

Purchase. For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The fair market value of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

Example. A father sold 50% of his business to his son. The resulting partnership had a profit of \$60,000. Capital is a material income-producing factor. The father performed services worth \$24,000, which is reasonable compensation, and the son performed no services. The \$24,000 must be allocated to the father as compensation. Of the remaining \$36,000 of profit due to capital, at least 50%, or \$18,000, must be allocated to the father since he owns a 50% capital interest. The son's share of partnership profit cannot be more than \$18,000.

Husband-wife partnership. If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from

the business on Form 1065. They should **not** report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor.

Each spouse should carry his or her share of the partnership income or loss from Schedule K-1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Schedule SE (Form 1040), *Self-Employment Tax*. This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based.

Partnership Agreement

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

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extension of time.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

Terminating a Partnership

A partnership terminates when:

- 1) All of its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership or a limited liability company classified as a partnership, or
- 2) At least 50% of the total interest in partnership capital and profits is sold or exchanged within a 12-month period, including a sale or exchange to another partner.

See Regulations section 1.708-1(b)(1) for more information on the termination of a partnership. For special rules that apply to a merger, consolidation, or division of a partnership, see Regulations section 1.708-1(b)(2).

Date of termination. The partnership's tax year ends on the date of termination. For purposes of (1) above, the date of termination is the date the partnership completes the winding up of its affairs. For purposes of (2) above, the date of termination is the date of the sale or exchange of a partnership interest that, by itself or together with other sales or exchanges in the preceding 12 months, transfers an interest of 50% or more in both capital and profits.

Short period return. If a partnership is terminated before the end of the tax year, Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is

due the 15th day of the fourth month following the date of termination. See *Partnership Return (Form 1065)*, later, for information about filing Form 1065.

Exclusion From Partnership Rules

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as a partnership for federal income tax purposes if all the partners agree. However, the partners are not exempt from the rule that limits a partner's distributive share of partnership loss. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year, discussed later.

Investing partnership. An investing partnership can be excluded if the participants in the joint purchase, retention, sale, or exchange of investment property:

- 1) Own the property as co-owners.
- 2) Reserve the right separately to take or dispose of their shares of any property acquired or retained.
- 3) Do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange the investment property. Each separate participant can delegate authority to purchase, sell, or exchange his or her share of the investment property for the time being for his or her account, but not for a period of more than a year.

Operating agreement partnership. An operating agreement partnership group can be excluded if the participants in the joint production, extraction, or use of property:

- 1) Own the property as co-owners, either in fee or under lease or other form of contract granting exclusive operating rights.
- 2) Reserve the right separately to take in kind or dispose of their shares of any property produced, extracted, or used.
- 3) Do not jointly sell services or the property produced or extracted. Each separate participant can delegate authority to sell his or her share of the property produced or extracted for the time being for his or her account, but not for a period of time in excess of the minimum needs of the industry, and in no event for more than one year. However, this does not apply to an unincorporated organization one of whose principal purposes is cycling, manufacturing, or processing for persons who are not members of the organization.

Electing the exclusion. An eligible organization that wishes to be excluded from the partnership rules must make the election not later

than the time for filing the partnership return for the first tax year for which exclusion is desired. See section 1.761-2(b) of the Income Tax Regulations for the procedures to follow.

Tax Year

Taxable income is figured on the basis of a tax year. A "tax year" is the accounting period used for keeping records and reporting income and expenses.

Partnership. A partnership determines its tax year as if it were a taxpayer. However, there are limits on the year it can choose. In general, a partnership must use its required tax year. Exceptions to this rule are discussed under *Exceptions to Required Tax Year*, later.

Partners. Partners can change their tax year only if they receive permission from the IRS. This also applies to corporate partners who are usually allowed to change their accounting periods without prior approval if they meet certain conditions.

Closing of tax year. Generally, the partnership's tax year is not closed because of the sale, exchange, or liquidation of a partner's interest, the death of a partner, or the entry of a new partner. However, if a partner sells, exchanges, or liquidates his or her entire interest, the partnership's tax year is closed for that partner.

Required Tax Year

A partnership generally must conform its tax year to its partners' tax years as follows:

- 1) **Majority interest tax year.** If one or more partners having the same tax year own an interest in partnership profits and capital of more than 50% (a majority interest), the partnership must use the tax year of those partners.
Testing day. The partnership determines if there is a majority interest tax year on the testing day, which is usually the first day of the partnership's current tax year.
Change in tax year. If a partnership's majority interest tax year changes, it will not be required to change to another tax year for 2 years following the year of change.
- 2) **Principal partner.** If there is no majority interest tax year, the partnership must use the tax year of all its principal partners. A principal partner is one who has a 5% or more interest in the profits or capital of the partnership.
- 3) **Least aggregate deferral of income.** If there is no majority interest tax year and the principal partners do not have the same tax year, the partnership generally must use a tax year that results in the least aggregate deferral of income to the partners.

Least aggregate deferral of income. The tax year that results in the least aggregate deferral of income is determined as follows:

- 1) Determine the number of months of deferral for each partner using one partner's tax year. Find the months of deferral by counting the months from the end of that tax year forward to the end of each other partner's tax year.
- 2) Multiply each partner's months of deferral determined in step (1) by that partner's share of interest in the partnership profits for the tax year used in step (1).
- 3) Add the amounts in step (2) to get the aggregate (total) deferral for the tax year used in step (1).
- 4) Repeat steps (1) through (3) for each partner's tax year that is different from the other partners' years.

The partner's tax year that results in the lowest number in step (3) above is the tax year that must be used by the partnership. If more than one year qualifies as the tax year that has the least aggregate deferral of income, the partnership can choose any year that qualifies. However, if one of the years that qualifies is the partnership's existing tax year, the partnership must retain that tax year.

Special de minimis rule. If the tax year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current tax year, the partnership's current tax year is treated as the tax year with the least aggregate deferral.

Example. Rose and Irene each have a 50% interest in a partnership that uses a fiscal year ending June 30. Rose uses a calendar year while Irene has a fiscal year ending November 30. The partnership must change its tax year to a fiscal year ending November 30 because this results in the least aggregate deferral of income to the partners. This was determined as shown in the following table.

Year End	Year	Profits of Interest	Months of Deferral	Interest × Deferral
12/31:	End	Interest	Deferral	Deferral
Rose	12/31	0.5	-0-	-0-
Irene	11/30	0.5	11	5.5
Total Deferral				5.5

Year End	Year	Profits of Interest	Months of Deferral	Interest × Deferral
11/30:	End	Interest	Deferral	Deferral
Rose	12/31	0.5	1	0.5
Irene	11/30	0.5	-0-	-0-
Total Deferral				0.5

Procedures. Generally, determination of the partnership's required tax year is made at the beginning of the partnership's current tax year. However, the IRS can require the partnership

to use another day or period that will more accurately reflect the ownership of the partnership.

Any required change under these rules will be treated as initiated by the partnership with the consent of the IRS. No formal application for a change in tax year is needed.

Notifying IRS. Any partnership that adopts or changes its tax year as required must notify the IRS by writing at the top of the first page of its tax return for its first required tax year, "FILED UNDER SECTION 806 OF THE TAX REFORM ACT OF 1986."

Short period return. When a partnership changes its tax year, a short period return must be filed. The short period return covers the months between the end of the partnership's prior tax year and the beginning of its new tax year. If the change is to the tax year resulting in the least aggregate deferral of income, a statement must be attached to this short period return showing the computations that determined that tax year. The short period return must indicate at the top of page 1, "FILED UNDER SECTION 1.706-1T."

Exceptions To Required Tax Year

There are two exceptions to the required tax year rule.

Business purpose tax year. If a partnership establishes an acceptable business purpose for having a tax year different from its required tax year, the different tax year can be used. The deferral of income to the partners is not considered a business purpose.

See *Business Purpose Tax Year* in Publication 538 for more information.

Section 444 election. Partnerships can elect under section 444 of the Internal Revenue Code to use a tax year different from the required tax year. Certain restrictions apply to this election. In addition, the electing partnership may be required to make a payment representing the value of the extra tax deferral to the partners. The election does not apply to any partnership that establishes a business purpose for a different period.

See *Section 444 Election* in Publication 538 for more information.

Partnership Return (Form 1065)

Each partnership engaged in a trade or business must file a return on Form 1065 showing its income, deductions, and other required information. In addition, the partnership return shows the names and addresses of each partner and each partner's distributive share of taxable income. This is an information return and must be signed by a general partner. If a limited liability company, discussed earlier, is treated as a partnership, it must file Form 1065 and one of its members must sign the return.

The first return of the partnership is not required to be filed until the first tax year the partnership has income or deductions. The partnership is not required to file Form 1065 for any tax year it receives no income and has no expenses. It is not considered to be engaged in a trade or business that year. See the instructions for Form 1065 for more information.

Due date. Form 1065 generally must be filed by April 15 following the close of the partnership's tax year if its accounting period is the calendar year. A fiscal year partnership generally must file its return by the 15th day of the 4th month following the close of its fiscal year.

If a partnership needs more time to file its return, it should file Form 8736 by the regular due date of its Form 1065. The automatic extension is 3 months.

If a partnership has made a section 444 election to use a tax year other than a required tax year, discussed earlier, the filing of an application for extension does not extend the time for making any required payment. Nor does an extension of time for filing a partnership return extend the time for filing a partner's personal income tax return.

If the date for filing a return or making a tax payment falls on a Saturday, Sunday, or legal holiday, the partnership can file the return or make the payment on the next business day.

Schedule K-1 due to partners. The partnership must furnish copies of Schedule K-1 (Form 1065) to the partners by the date Form 1065 is required to be filed, including extensions.

Penalties

To help ensure that returns are filed correctly and on time, the law provides penalties for failure to do so.

Failure to file. A penalty is assessed against any partnership that must file a partnership return and fails to file on time, including extensions, or fails to file a return with all the information required. The penalty is \$50 times the total number of partners in the partnership during any part of the tax year for each month (or part of a month) the return is late or incomplete, up to 5 months.

The penalty will not be imposed if the partnership can show reasonable cause for its failure to file a complete or timely return. Certain small partnerships (with 10 or fewer partners) meet this reasonable cause test if all of the following apply:

- 1) Each partner is a natural person (other than a nonresident alien) or an estate.
- 2) Each partner's share of each partnership item is the same as his or her share of every other item.
- 3) All partners have fully reported their shares of partnership income, deductions, and credits on their timely filed individual income tax returns.

The failure to file penalty is assessed against the partnership. However, each partner is individually liable for the penalty to the extent the partner is liable for partnership debts in general.

If the partnership wants to contest the penalty, it must pay the penalty and sue for refund in a U.S. District Court or the U.S. Court of Federal Claims.

Failure to furnish copies to the partners.

The partnership must furnish copies of Schedule K-1 to the partners. A penalty for each statement not furnished will be assessed against the partnership unless the failure to do so is due to reasonable cause and not willful neglect.

Trust fund recovery penalty. A person responsible for withholding, accounting for, or depositing or paying withholding taxes who willfully fails to do so can be held liable for a penalty equal to the tax not paid, plus interest.

“Willfully” in this case means voluntarily, consciously, and intentionally. Paying other expenses of the business instead of the taxes due is considered willful behavior.

A responsible person can be an officer of a corporation, a partner, a sole proprietor, or an employee of any form of business. This may include a trustee or agent with authority over the funds of the business.

Other penalties. Criminal penalties can be imposed for willful failure to file, tax evasion, or making a false statement.

Other penalties include those for:

- 1) Not supplying a taxpayer identification number.
- 2) Not furnishing information returns.
- 3) Overstating tax deposit claims.
- 4) Underpaying tax due to a valuation overstatement.
- 5) Not furnishing information on tax shelters.
- 6) Promoting abusive tax shelters.

However, certain penalties may not be imposed if there is reasonable cause for noncompliance.

Partnership Income or Loss

A partnership computes its income and files its return in the same manner as an individual. However, certain deductions are not allowed to the partnership.

Separately stated items. Certain items must be separately stated on the partnership return and included as separate items on the partners' returns. These items, listed on Schedule K (Form 1065), are:

- 1) Ordinary income or loss from trade or business activities.
- 2) Net income or loss from rental real estate activities.

- 3) Net income or loss from other real estate activities.
- 4) Gains and losses from sales or exchanges of capital assets.
- 5) Gains and losses from sales or exchanges of section 1231 property.
- 6) Charitable contributions.
- 7) Dividends (passed through to corporate partners) that qualify for the dividends-received deduction.
- 8) Taxes paid or accrued to foreign countries and U.S. possessions.
- 9) Other items of income, gain, loss, deduction, or credit, as provided by regulations. Examples include nonbusiness expenses, intangible drilling and development costs, and soil and water conservation expenses.

Elections. The partnership makes most choices about how to compute income. These include choices for:

- 1) Accounting methods.
- 2) Depreciation methods.
- 3) Accounting for specific items, such as depletion or installment sales.
- 4) Nonrecognition of gain on involuntary conversions of property.
- 5) Amortization of certain organization fees and business start-up costs of the partnership.

However, each partner chooses how to treat the partner's share of foreign and U.S. possessions taxes, certain mining exploration expenses, and income from cancellation of debt.

More information. For more information on the following topics, see the listed publication.

- 1) Accounting methods: Publication 538.
- 2) Depreciation methods: Publication 946.
- 3) Installment sales: Publication 537.
- 4) Amortization and depletion: Publication 535, chapters 12 and 13.
- 5) Involuntary conversions: Publication 544 (condemnations) and Publication 547 (casualties and thefts).

Organization expenses and syndication fees. Neither the partnership nor any partner can deduct, as a current expense, amounts paid or incurred to organize a partnership or to promote the sale of, or to sell, an interest in the partnership.

The partnership can choose to amortize certain organization expenses over a period of not less than 60 months. The period must start with the month the partnership begins business. This election is irrevocable and the period the partnership chooses in this election cannot be changed. If the partnership elects to amortize these expenses and is liquidated before the end of the amortization period, the remaining balance in this account may be deductible as a loss.

Making the election. The election to amortize organization expenses is made by attaching a statement to the partnership's return for the tax year the partnership begins its business. The statement must provide the following information:

- 1) A description of each organization expense incurred (whether or not paid).
- 2) The amount of each expense.
- 3) The date each expense was incurred.
- 4) The month the partnership began its business.
- 5) The number of months (not less than 60) over which the expenses are to be amortized.

A cash basis taxpayer must also indicate for each expense the amount paid before the end of the year for each expense. Expenses less than \$10 need not be separately listed, provided the total amount is listed with the dates on which the first and last of the expenses were incurred.

Amortizable expenses. Amortization applies to expenses that:

- 1) Are incident to the creation of the partnership.
- 2) Are chargeable to a capital account.
- 3) Are the type that would be amortized if they were incurred in the creation of a partnership having a fixed life.

To satisfy (1) and (2) above, an expense must be incurred during the period beginning at a point which is a reasonable time before the partnership begins business and ending with the date for filing the partnership return (not including extensions) for the tax year in which the partnership begins business. In addition, the expense must be for creating the partnership and not for starting or operating the partnership trade or business.

To satisfy (3) above, the expense must be for a type of item normally expected to benefit the partnership throughout its entire life.

Organization expenses that can be amortized include:

- 1) Legal fees for services incident to the organization of the partnership, such as negotiation and preparation of a partnership agreement.
- 2) Accounting fees for services incident to the organization of the partnership.
- 3) Filing fees.

Expenses not amortizable. Expenses that cannot be amortized (regardless of how the partnership characterizes them) include expenses connected with:

- 1) Acquiring assets for the partnership or transferring assets to the partnership.
- 2) Admitting or removing partners other than at the time the partnership is first organized.
- 3) Making a contract relating to the operation of the partnership trade or business

(even if the contract is between the partnership and one of its members).

- 4) Syndicating the partnership. Syndication expenses, such as commissions, professional fees, and printing costs connected with the issuing and marketing of interests in the partnership, are capitalized. They can never be deducted by the partnership, even if the syndication is unsuccessful.

Partner's Distributive Share

A partner's taxable income for a tax year includes his or her distributive share of certain partnership items for the partnership's tax year ending with or within the partner's tax year.

Partnership agreement. Generally, the partnership agreement determines a partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit. The partnership agreement or any modification will be disregarded if the allocations to a partner under the agreement do not have substantial economic effect. If the allocation does not have substantial economic effect or the partnership agreement does not provide for the allocation, the partner's distributive share of the partnership items is determined by the partner's interest in the partnership.

Substantial economic effect. An allocation has substantial economic effect if both of the following apply:

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

Nonrecourse liability. A nonrecourse liability is one for which no partner or related person has any personal liability. An allocation of a loss, deduction, or partnership expense attributable to nonrecourse liabilities not deductible or chargeable to capital cannot have economic effect. A partner's share of nonrecourse deductions is determined by his or her interest in the partnership. For the rules on allocating nonrecourse deductions, see section 1.704-2 of the Income Tax Regulations.

Partner's interest in partnership. If a partner's distributive share of a partnership item cannot be determined under the partnership agreement, it is determined by his or her interest in the partnership. The partner's interest is determined by taking all of the following into account.

- 1) The partner's contributions to the partnership.
- 2) The interests of all partners in economic profits and losses (if different from interests in taxable income or loss) and in cash flow and other nonliquidating distributions.
- 3) The rights of the partners to distributions of capital upon liquidation.

Gross income. When it is necessary to determine the gross income of a partner, the partner's gross income includes his or her distributive share of the partnership's gross income. For example, the partner's share of the partnership gross income is used in determining whether an income tax return must be filed by that partner.

Estimated tax. Partners may have to make payments of estimated tax as a result of partnership income.

Generally, the required estimated tax payment for individuals is the smaller of:

- 1) 90% of the total expected tax for the current year, or
- 2) 100% of the total tax shown on the prior year's tax return.

However, individuals with adjusted gross income of more than \$150,000 (\$75,000 if married and filing a separate return) must substitute 110% in (2) above. This rule does not apply to individuals who receive at least two-thirds of their gross income from farming or fishing.

See Publication 505 for more information.

Self-employment tax. A partner is not an employee of the partnership. The partner's distributive share of ordinary income from a partnership is generally included in figuring net earnings from self-employment. If an individual partner has net earnings from self-employment of \$400 or more for the year, the partner must figure self-employment tax on Schedule SE (Form 1040). For more information on self-employment tax, see Publication 533.

Alternative minimum tax. To figure alternative minimum tax, a partner must separately take into account any distributive share of items of income and deductions that enter into the computation of alternative minimum taxable income. For information on which items of income and deductions are affected, see the Form 6251 instructions.

Reporting Distributive Share

A partner must report his or her distributive share of partnership items on his or her tax return, whether or not it is actually distributed. However, a partner's distributive share of a loss may be limited. See *Limits on Losses*, later. These items are reported to the partner on Schedule K-1 (Form 1065). See the *Partner's Instructions for Schedule K-1 (Form 1065)* for more information.

To determine the allowable amount of any deduction or exclusion subject to a limit, a partner must combine any separate deductions or exclusions on his or her income tax return with the distributive share of partnership deductions or exclusions before applying the limit.

Character of items. The character of each item of income, gain, loss, deduction, or credit included in a partner's distributive share is determined as if the partner:

- 1) Realized the item directly from the same source as the partnership, or
- 2) Incurred the item in the same manner as the partnership.

For example, a partner's distributive share of gain from the sale of partnership depreciable property used in the trade or business of the partnership is treated as gain from the sale of depreciable property the partner used in a trade or business.

Inconsistent treatment of items. Partners must generally treat partnership items the same way on their individual tax returns as they are treated on the partnership return. If a partner treats an item differently on his or her individual return, the IRS can immediately assess and collect any tax and penalties that result from adjusting the item to make it consistent with the partnership return. However, this rule will not apply if a partner identifies the different treatment by filing Form 8082, *Notice of Inconsistent Treatment or Amended Return*, with his or her return.

Consolidated audit procedures. Under current examination procedures, the tax treatment of any partnership item is determined at the partnership level in a consolidated audit proceeding, rather than at the individual partner's level. After the proper treatment is determined at the partnership level, the IRS can automatically make related adjustments to the tax returns of the partners, based on their share of the adjusted items.

The consolidated audit procedures do not apply to small partnerships that have 10 or fewer partners who are individuals (other than nonresident alien individuals) or estates. This exception applies only if each partner's share of every partnership item is the same as that partner's share of every other item. However, small partnerships can make an election to have these procedures apply.

Limits on Losses

Partner's adjusted basis. A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of the partner's partnership interest. The adjusted basis is figured at the end of the partnership's tax year in which the loss occurred, before taking the loss into account. Any loss more than the partner's adjusted basis is not deductible for that year. However, any loss not allowed for this reason will be allowed as a deduction (up

to the partner's basis) at the end of any succeeding year in which the partner increases his or her basis to more than zero. See *Basis of Partner's Interest*, later.

Example. Mike and Joe are equal partners in a partnership. Mike files his individual return on a calendar year basis. The partnership return is also filed on a calendar year basis. The partnership incurred a \$10,000 loss last year and Mike's distributive share of the loss is \$5,000. The adjusted basis of his partnership interest before considering his share of last year's loss was \$2,000. He could claim only \$2,000 of the loss on last year's individual return. The adjusted basis of his interest at the end of last year was then reduced to zero.

The partnership showed an \$8,000 profit for this year. Mike's \$4,000 share of the profit increased the adjusted basis of his interest by \$4,000 (not taking into account the \$3,000 excess loss he could not deduct last year). His return for this year will show his \$4,000 distributive share of this year's profits and the \$3,000 loss not allowable last year. The adjusted basis of his partnership interest at the end of this year is \$1,000.

Not-for-profit activity. Deductions relating to an activity not engaged in for profit are limited. For a discussion of the limits, see chapter 1 in Publication 535.

At-risk limits. At-risk rules apply to most trade or business activities, including activities conducted through a partnership. The at-risk rules limit a partner's deductible loss to the amounts for which that partner is considered at risk in the activity.

A partner is considered at risk for:

- 1) The money and adjusted basis of any property he or she contributed to the activity.
- 2) The partner's share of net income retained by the partnership.
- 3) Certain amounts borrowed by the partnership for use in the activity if the partner is personally liable for repayment or the amounts borrowed are secured by the partner's property (other than property used in the activity).

A partner is not considered at risk for amounts protected against loss through guarantees, stop-loss agreements, or similar arrangements. Nor is the partner at risk for amounts borrowed if the lender has an interest in the activity (other than as a creditor) or is related to a person (other than the partner) having such an interest.

For more information on determining the amount at risk, see Publication 925.

Passive activities. Generally, section 469 of the Internal Revenue Code limits the amount a partner can deduct for passive activity losses and credits. The passive activity limits do not apply to the partnership. Instead, they apply to each partner's share of loss or credit from passive activities. Because the treatment of each partner's share of partnership income, loss, or credit depends on the nature of the activity

that generated it, the partnership must report income, loss, and credits separately for each activity.

Generally, passive activities include a trade or business activity in which the partner does not materially participate. The level of each partner's participation must be determined by the partner.

Rental activities. Passive activities also include rental activities, regardless of the partner's participation. However, a rental real estate activity in which the partner materially participates is not considered a passive activity. The partner must also meet both of the following conditions for the tax year:

- 1) More than half of the personal services the partner performs in any trade or business are in a real property trade or business in which the partner materially participates.
- 2) The partner performs more than 750 hours of service in real property trades or businesses in which the partner materially participates.

Limited partners. Limited partners are generally not considered to materially participate in trade or business activities conducted through partnerships.

More information. For more information on passive activities, see Publication 925 and the instructions to Forms 1065 and 8582.

Partner's Exclusions and Deductions

Cancellation of qualified real property business debt. A partner other than a C corporation can elect to exclude from gross income the partner's distributive share of income from cancellation of the partnership's qualified real property business debt. This is a debt (other than a qualified farm debt) incurred or assumed by the partnership in connection with real property used in its trade or business and secured by that property. A debt incurred or assumed after 1992 qualifies only if it was incurred or assumed to acquire, construct, reconstruct, or substantially improve such property. A debt incurred to refinance a qualified real property business debt qualifies, but only up to the refinanced debt.

A partner who elects the exclusion must reduce the basis of his or her depreciable real property by the amount excluded. For this purpose, a partnership interest is treated as depreciable real property to the extent of the partner's share of the partnership's depreciable real property. If the partner reduces the basis of his or her partnership interest by the excluded amount, the partnership must make a corresponding reduction in the basis of its depreciable real property with respect to that partner.

To elect the exclusion, the partner must file Form 982 with his or her original income tax return. The election can be made with an amended return only if the partner shows reasonable cause for not making it with the original return.

Exclusion limit. The partner's exclusion cannot be more than the smaller of the following two amounts.

- 1) The partner's share of the excess (if any) of:
 - a) The outstanding principal of the debt immediately before the cancellation, over
 - b) The fair market value (as of that time) of the property securing the debt, reduced by the outstanding principal of other qualified real property business debt secured by that property (as of that time).
- 2) The total adjusted bases of depreciable real property held by the partner immediately before the cancellation (other than property acquired in contemplation of the cancellation).

Effect on partner's basis. Because of offsetting adjustments, the cancellation of a partnership debt does not usually cause a net change in the basis of a partnership interest. Each partner's basis is:

- 1) Increased by his or her share of the partnership income from the cancellation of debt (whether or not the partner excludes the income), and
- 2) Reduced by the deemed distribution resulting from the reduction in his or her share of partnership liabilities.

(See *Adjusted Basis* under *Basis of Partner's Interest*, later.) The basis of a partner's interest will change only if the partner's share of income is different from the partner's share of debt.

As explained earlier, however, a partner's election to exclude income from the cancellation of debt may reduce the basis of the partner's interest to the extent the interest is treated as depreciable real property.

Basis of depreciable real property reduced. If the basis of depreciable real property is reduced, and the property is disposed of, then for purposes of determining recapture under section 1250 of the Internal Revenue Code:

- 1) Any such basis reduction is treated as a deduction allowed for depreciation, and
- 2) The determination of what would have been the depreciation adjustment under the straight line method is made as if there had been no such reduction.

Therefore, the basis reduction recaptured as ordinary income is reduced over the time the partnership continues to hold the property, as the partnership forgoes depreciation deductions due to the basis reduction.

More information. See chapter 5 in Publication 334 for more information on qualified real property debt.

Section 179 deduction. A partner can elect to deduct all or part of the cost of certain assets under section 179 of the Internal Revenue Code.

Limits. The section 179 deduction is subject to certain limits that apply to the partnership and to each partner. The partnership determines its section 179 deduction subject to the limits. It then allocates the deduction among its partners.

Each partner adds the amount allocated from the partnership (shown on Schedule K-1) to his or her other nonpartnership section 179 costs and then applies the maximum dollar limit to this total. To determine if a partner has exceeded the \$200,000 investment limit, the partner does not include any of the cost of section 179 property placed in service by the partnership. After the maximum dollar limit and investment limit are applied, the remaining cost of the partnership and nonpartnership section 179 property is subject to the taxable income limit.

Figuring partnership's taxable income.

For purposes of the taxable income limit, taxable income of a partnership is figured by adding together the net income (or loss) from all trades or businesses actively conducted by the partnership during the tax year.

Partner's share of partnership taxable income. For purposes of a partner's taxable income limit, a partner who is engaged in the active conduct of one or more of a partnership's trades or businesses includes his or her allocable share of taxable income derived from the partnership's active conduct of any trade or business.

Basis adjustment. A partner who is allocated section 179 expenses from the partnership must reduce the basis of his or her partnership interest by the total section 179 expenses allocated, regardless of whether the full amount allocated can be currently deducted. See *Adjusted Basis* under *Basis of Partner's Interest*, later. If a partner disposes of his or her interest in a partnership, the partner's basis for determining gain or loss is increased by any outstanding carryover of section 179 expenses allocated from the partnership.

The basis of a partnership's section 179 property must be reduced by the section 179 deduction elected by the partnership. This reduction of basis must be made even if any partner cannot deduct his or her entire share of the section 179 deduction because of the limits.

More information. See Publication 946 for more information on the section 179 deduction.

Partnership expenses paid by partner. In general, a partner cannot deduct partnership expenses paid out of personal funds unless the partnership agreement requires the partner to pay the expenses. These expenses are usually considered incurred and deductible by the partnership.

If an employee of the partnership performs part of a partner's duties and the partnership agreement requires the partner to pay the employee out of personal funds, the partner can deduct the payment as a business expense.

Interest expense for distributed loan. If the partnership distributes borrowed funds to a

partner, the partnership should list the partner's share of interest expense for these funds as "Interest expense allocated to debt-financed distributions" under "Other deductions" on the partner's Schedule K-1. The partner deducts this interest on his or her tax return depending on how the partner uses the funds. See chapter 8 in Publication 535 for more information on the allocation of interest expense related to debt-financed distributions.

Debt-financed acquisitions. The interest expense on loan proceeds used to purchase an interest in, or make a contribution to, a partnership must be allocated as explained in chapter 8 of Publication 535.

Partnership Distributions

Partnership distributions include the following:

- 1) A withdrawal by a partner in anticipation of the current year's earnings.
- 2) A distribution of the current year's or prior years' earnings not needed for working capital.
- 3) A complete or partial liquidation of a partner's interest.
- 4) A distribution to all partners in a complete liquidation of the partnership.

A partnership distribution is not taken into account in determining the partner's distributive share of partnership income or loss. If any gain or loss from the distribution is recognized by the partner, it must be reported on his or her return for the tax year in which the distribution is received. Money or property withdrawn by a partner in anticipation of the current year's earnings is treated as a distribution received on the last day of the partnership's tax year.

Effect on partner's basis. A partner's adjusted basis in his or her partnership interest is decreased (but not below zero) by the money and adjusted basis of property distributed to the partner. See *Adjusted Basis* under *Basis of Partner's Interest*, later.

Effect on partnership. A partnership does not recognize any gain or loss because of distributions it makes to partners. The partnership may be able to elect to adjust the basis of its undistributed property, as explained later under *Adjusting the Basis of Partnership Property*.

Partner's Gain or Loss

A partner generally recognizes gain on a partnership distribution only to the extent any money (and marketable securities treated as money) included in the distribution exceed the adjusted basis of the partner's interest in the partnership. Any gain recognized is treated as

capital gain from the sale of the partnership interest on the date of the distribution. If partnership property (other than marketable securities treated as money) is distributed to a partner, he or she generally does not recognize any gain until the sale or other disposition of the property. For exceptions to these rules, see *Certain distributions treated as a sale or exchange* and following discussions, later.

Example. The adjusted basis of Jo's partnership interest is \$14,000. She receives a distribution of \$8,000 cash and land that has an adjusted basis of \$2,000 and a fair market value of \$3,000. Because the cash received does not exceed the basis of her partnership interest, Jo does not recognize any income on the distribution. Any gain on the land will be recognized when she sells or otherwise disposes of it. The distribution decreases the adjusted basis of Jo's partnership interest to \$4,000 [$\$14,000 - (\$8,000 + \$2,000)$].

Marketable securities treated as money.

Generally, a marketable security distributed to a partner after December 8, 1994, is treated as money in determining whether gain is recognized on the distribution. This treatment, however, does not generally apply if that partner contributed the security to the partnership or an investment partnership made the distribution to an eligible partner.

The amount treated as money is the security's fair market value when distributed, reduced (but not below zero) by the excess (if any) of:

- 1) The partner's distributive share of the gain that would be recognized had the partnership sold all its marketable securities of the same class and issuer as the distributed security at their fair market value immediately before the transaction resulting in the distribution, over
- 2) The partner's distributive share of the gain that would be recognized had the partnership sold all such securities it still held after the distribution at the fair market value in (1).

For the definition of marketable securities and other information, see section 731(c) of the Internal Revenue Code.

Loss on distribution. A partner does not recognize loss on a partnership distribution unless all of the following requirements are met:

- 1) The adjusted basis of the partner's interest in the partnership exceeds the distribution.
- 2) The partner's entire interest in the partnership is liquidated.
- 3) The distribution is in money, unrealized receivables, or inventory items.

There are exceptions to these general rules. See the following discussions. Also, see *Liquidation at Partner's Retirement or Death*, later.

Certain distributions treated as a sale or exchange. When a partnership distributes the

following items, the distribution may be treated as a sale or exchange of property that is not a capital asset.

- 1) Unrealized receivables or substantially appreciated inventory items to a partner in exchange for any part of the partner's interest in other partnership property, including money.
- 2) Other property (including money) in exchange for any part of a partner's interest in unrealized receivables or substantially appreciated inventory items.

See *Payments for Unrealized Receivables and Inventory Items*, later.

This treatment does not apply in the following situations:

- 1) A distribution of property to the partner who contributed the property to the partnership.
- 2) Certain payments made to a retiring partner or successor in interest of a deceased partner.

Distribution of partner's debt. If a partnership acquires a partner's debt and extinguishes the debt by distributing it to the partner, the partner will recognize capital gain or loss to the extent the fair market value of the debt differs from the basis of the debt (determined under the rules discussed in *Partner's Basis for Distributed Property*, later).

The partner is treated as having satisfied the debt for its fair market value. If the issue price (adjusted for any premium or discount) of the debt exceeds its fair market value when distributed, the partner may have to include that amount in income as canceled debt.

Similarly, a deduction may be available to a corporate partner if the fair market value of the debt at the time of distribution exceeds its adjusted issue price.

Net precontribution gain. A partner generally must recognize gain on the distribution of property (other than money) if the partner contributed appreciated property to the partnership during the 5-year period before the distribution. The gain recognized is the lesser of:

- 1) The excess of:
 - a) The fair market value of the property received in the distribution, over
 - b) The adjusted basis of the partner's interest in the partnership immediately before the distribution, reduced (but not below zero) by any money received in the distribution, **or**
- 2) The "net precontribution gain" of the partner. This is the net gain the distributee partner would recognize if all the property contributed by the partner within 5 years of the distribution, and held by the partnership immediately before the distribution, were distributed to another partner, other than a partner who owns more than 50% of the partnership. This also applies if the partnership distributes the property to another partner. See *Distribution of*

contributed property to another partner under *Contribution of Property*, later.

The character of the gain is determined by reference to the character of the net precontribution gain. This gain is in addition to any gain the partner must recognize if the money distributed is more than his or her basis in the partnership.

For these rules, the term "money" includes marketable securities treated as money, as discussed earlier.

Effect on basis. The adjusted basis of the partner's interest in the partnership is increased by any net precontribution gain recognized by the partner. Other than for purposes of determining the gain, the increase is treated as occurring immediately before the distribution. See *Basis of Partner's Interest*, later.

The partnership must adjust its basis in any property the partner contributed within 5 years of the distribution to reflect any gain that partner recognizes under this rule.

Exceptions. If any of the distributed property is property the partner had contributed to the partnership, the property is not taken into account in determining either of the following.

- 1) The excess of the fair market value of any property received over the adjusted basis of the partner's interest in the partnership.
- 2) The partner's net precontribution gain.

If any interest in an entity is distributed, this exception does not apply to the extent that the value of the interest is due to property contributed to the entity after the interest in the entity had been contributed to the partnership.

Recognition of gain under this rule also does not apply to a distribution of either:

- 1) Unrealized receivables or substantially appreciated inventory items of the partnership, discussed later, in exchange for all or part of a partner's interest in other partnership property.
- 2) Other partnership property in exchange for all or part of a partner's interest in unrealized receivables or substantially appreciated inventory items of the partnership.

Partner's Basis for Distributed Property

Unless there is a complete liquidation of a partner's interest, the basis of property (other than money) distributed to the partner by a partnership is its adjusted basis to the partnership immediately before the distribution. However, the basis of the property to the partner cannot be more than the adjusted basis of his or her interest in the partnership reduced by any money received in the same transaction.

Example 1. The adjusted basis of Beth's partnership interest is \$30,000. She receives a distribution of property that has an adjusted basis of \$20,000 to the partnership and \$4,000 in cash. Her basis for the property is \$20,000.

Example 2. The adjusted basis of Mike's partnership interest is \$10,000. He receives a

distribution of \$4,000 cash and property that has an adjusted basis to the partnership of \$8,000. His basis for the distributed property is limited to \$6,000 (\$10,000 – \$4,000, the cash he receives).

Complete liquidation of partner's interest.

The basis of property received in complete liquidation of a partner's interest is the adjusted basis of the partner's interest in the partnership reduced by any money distributed to the partner in the same transaction.

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

Basis divided among properties. If the basis of property received is the adjusted basis of the partner's interest in the partnership (reduced by money received in the same transaction), it must be divided among the properties distributed to the partner. The basis must first be allocated to unrealized receivables and inventory items included in the distribution.

The unrealized receivables or inventory items generally cannot take a higher basis in the partner's hands than their common adjusted basis to the partnership immediately before the distribution. However, the items could have a higher basis if the distribution is treated as a sale or exchange. See *Special adjustment to basis of property received*, later.

Any basis not allocated to unrealized receivables and inventory items must then be divided among any other properties distributed to the partner in the same transaction. The division must be in proportion to their adjusted bases in the hands of the partnership before the distribution.

Example. The adjusted basis of Ted's partnership interest is \$30,000. In complete liquidation of his interest, he receives \$10,000 in cash, his share of the inventory items having a basis to the partnership of \$12,000, and two parcels of land having adjusted bases to the partnership of \$12,000 and \$4,000.

The basis of Ted's partnership interest is reduced to \$20,000 by the \$10,000 cash. This \$20,000 basis is then divided among the properties he receives. The inventory items in his hands now have a basis of \$12,000. To divide the balance of \$8,000, he first adds the partnership's bases for the land (\$12,000 + \$4,000 = \$16,000). The bases of the two parcels of land in his hands are \$6,000 $[(12,000 \div 16,000) \times \$8,000]$ and \$2,000 $[(4,000 \div 16,000) \times \$8,000]$, respectively.

Partner's interest less than partnership basis. If the partnership's adjusted basis for the unrealized receivables and inventory items distributed to a partner is more than the adjusted basis of the partner's interest (reduced by any money distributed), the latter amount is allocated among these items in proportion to the partnership's adjusted bases for the items. The partner's basis for any other distributed property is zero.

Example. Jenny's basis for her partnership interest is \$18,000. In a distribution in liquidation of her entire interest, she receives \$12,000 cash, her share of inventory items having an adjusted basis to the partnership of \$12,000, and unrealized receivables having a basis to the partnership of \$8,000. The basis of her partnership interest is first reduced to \$6,000 by the \$12,000 cash she receives. This \$6,000 basis is then divided proportionately between the inventory items and the unrealized receivables. Her basis for the inventory items is \$3,600 $[(12,000 \div 20,000) \times \$6,000]$. Her basis for the unrealized receivables is \$2,400 $[(8,000 \div 20,000) \times \$6,000]$.

Partner's interest more than partnership basis. If the basis of a partner's interest to be divided in a complete liquidation of the partner's interest is more than the partnership's adjusted basis for the unrealized receivables and inventory items distributed, and if no other property is distributed to which the partner can apply the remaining basis, the partner has a capital loss to the extent of the remaining basis of the partnership interest.

Special adjustment to basis of property received. A partner who acquired any part of his or her partnership interest in a sale or exchange or upon the death of another partner may be able to choose a special basis adjustment for the property. The special adjustment is made to the partnership's basis only for the purpose of figuring the partner's basis in the property. In order for the partner to choose the special adjustment, the distribution must be made within 2 years after the partner acquired the partnership interest. Also, the partnership must not have chosen the optional adjustment to basis, discussed later under *Adjusting the Basis of Partnership Property*, when the partner acquired the partnership interest.

If a partner chooses this special basis adjustment, the partner's basis for the property distributed is the same as it would have been if the partnership had chosen the optional adjustment to basis. However, this assigned basis is not reduced by any depletion or depreciation that would have been allowed or allowable if the partnership had previously chosen the optional adjustment.

The choice must be made with the partner's tax return for the year of the distribution if the distribution includes any property subject to depreciation, depletion, or amortization. If the choice does not have to be made for the distribution year, it must be made with the return for the first year in which the basis of the distributed property is pertinent in determining the partner's income tax.

A partner choosing this special basis adjustment must attach a statement to his or her tax return that the partner chooses under section 732(d) of the Internal Revenue Code to adjust the basis of property received in a distribution. The statement must show the computation of the special basis adjustment for the property distributed and list the properties to which the adjustment has been allocated.

Example. Bob purchased a 25% interest in X partnership for \$17,000 cash. At the time

of the purchase, the partnership owned inventory having a basis to the partnership of \$14,000 and a fair market value of \$16,000. His purchase price reflected \$500 of this difference $[(\$16,000 - \$14,000) \times 1/4]$. Thus, \$4,000 of the \$17,000 he paid was attributable to his share of inventory with a basis to the partnership of \$3,500.

Within 2 years after acquiring his interest, Bob withdrew from the partnership and for his entire interest received cash of \$1,500, inventory with a basis to the partnership of \$3,500, and other property with a basis of \$6,000. The value of the inventory received was 25% of the value of all partnership inventory. (It is immaterial whether the inventory he received was on hand when he acquired his interest.)

Since the partnership from which Bob withdrew did not make the optional adjustment to basis, he chose to adjust the basis of the inventory received. His share of the partnership's basis for the inventory is increased by \$500 (1/4 of the \$2,000 difference between the \$16,000 fair market value of the inventory and its \$14,000 basis to the partnership at the time he acquired his interest). The adjustment applies only for purposes of determining his new basis in the inventory, and **not** for purposes of partnership gain or loss on disposition.

The total to be allocated among the properties Bob received in the distribution is \$15,500 (\$17,000 basis of his interest - \$1,500 cash received). His basis in the inventory items is \$4,000 (\$3,500 partnership basis + \$500 special adjustment). The remaining \$11,500 is allocated to his new basis for the other property he received.

Mandatory adjustment. A partner does not always have a choice whether or not to use this special adjustment to basis. The special adjustment to basis **must** be made for a distribution of property, whether or not the distribution is made within 2 years after the partnership interest was acquired, if all of the following conditions existed when the partner received the partnership interest.

- 1) The fair market value of all partnership property (other than money) was more than 110% of its adjusted basis to the partnership.
- 2) If there had been a liquidation of the partner's interest immediately after it was acquired, an allocation of the basis of that interest under the general rule (discussed earlier under *Basis divided among properties*) would have decreased the basis of property that could not be depreciated, depleted, or amortized and increased the basis of property that could be.
- 3) The optional basis adjustment, if it had been chosen by the partnership, would have changed the partner's basis for the property actually distributed.

Marketable securities. A partner's basis in marketable securities received in a partnership distribution, as determined in the preceding discussions, is increased by any gain recognized by treating the securities as money. See *Marketable securities treated as money*

under *Partner's Gain or Loss*, earlier. The basis increase is allocated among the securities in proportion to their respective amounts of unrealized appreciation before the basis increase.

Transactions Between Partnership and Partners

For certain transactions between a partner and his or her partnership, the partner is treated as not being a member of the partnership. These transactions include:

- 1) Performing services for or transferring property to a partnership if—
 - a) There is a related allocation and distribution to a partner, and
 - b) The entire transaction, when viewed together, is properly characterized as occurring between the partnership and a partner not acting in the capacity of a partner.
- 2) Transferring money or other property to a partnership if—
 - a) There is a related transfer of money or other property by the partnership to the contributing partner or another partner, and
 - b) The transfers together are properly characterized as a sale or exchange of property.

Payments by accrual basis partnership to cash basis partner. A partnership that uses an accrual method of accounting cannot deduct any business expense owed to a cash basis partner until the amount is paid. However, this rule does not apply to guaranteed payments made to a partner, which are generally deductible when accrued.

Guaranteed Payments

Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner's distributive share of ordinary income. Guaranteed payments are not subject to income tax withholding.

The partnership generally deducts guaranteed payments on line 10 of Form 1065 as a business expense. They are also listed on Schedules K and K-1 of the partnership return. The individual partner reports guaranteed payments on Schedule E (Form 1040) as ordinary income, along with his or her distributive share of the partnership's other ordinary income.

Guaranteed payments made to partners for organizing the partnership or syndicating

interests in the partnership are capital expenses and are not deductible by the partnership. However, these payments must be included in the partners' individual income tax returns. See *Organization expenses and syndication fees*, earlier.

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

Example. Under a partnership agreement, Sandy is to receive 30% of the partnership income, but not less than \$8,000. The partnership has net income of \$20,000. Sandy's share, without regard to the minimum guarantee, is \$6,000 (30% × \$20,000). The guaranteed payment that can be deducted by the partnership is \$2,000 (\$8,000 – \$6,000). Sandy's income from the partnership is \$8,000, and the remaining \$12,000 will be reported by the other partners in proportion to their shares under the partnership agreement.

If the partnership net income had been \$30,000, there would have been no guaranteed payment since her share, without regard to the guarantee, would have been greater than the guarantee.

Self-employed health insurance premiums.

Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. The partnership can deduct the payments as a business expense and the partner must include them in gross income. However, if the partnership accounts for insurance paid for a partner as a reduction in distributions to the partner, the partnership cannot deduct the premiums.

For 1996, a partner who qualifies can deduct 30% of the health insurance premiums paid by the partnership on his or her behalf as an adjustment to income. The partner cannot deduct the premiums for any calendar month or part of a month in which the partner is eligible to participate in any subsidized health plan maintained by any employer of the partner or the partner's spouse. For more information on the self-employed health insurance deduction, see chapter 10 in Publication 535.

Note. For 1997, a partner who qualifies can deduct 40% of the health insurance premiums paid on his or her behalf as an adjustment to income.

Including payments in partner's income. Guaranteed payments are included in income in the partner's tax year in which the partnership's tax year ends.

Example 1. Under the terms of a partnership agreement, Erica is entitled to a fixed annual payment of \$10,000 without regard to the income of the partnership. Her distributive share of the partnership income is 10%. The partnership has \$50,000 of ordinary income after deducting the guaranteed payment. She

must include ordinary income of \$15,000 on her individual income tax return for her tax year in which the partnership's tax year ends (\$10,000 guaranteed payment + \$5,000 (\$50,000 × 10%) distributive share).

Example 2. Mike is a calendar year taxpayer who is a partner in a partnership. The partnership is on a fiscal year that ends January 31, 1997. Mike received guaranteed payments from the partnership from February 1, 1996, until December 31, 1996. He must include these guaranteed payments in income for 1997 and report them on his 1997 income tax return.

Payments resulting in loss. If a partnership agreement provides for guaranteed payments to a partner and the payments result in a partnership loss in which the partner shares, the partner must:

- 1) Report the full amount of the guaranteed payments as ordinary income, and
- 2) Separately take into account the appropriate distributive share of the partnership loss.

Sale or Exchange of Property

Special rules apply to a sale or exchange of property between a partnership and certain persons.

Losses. Losses will not be allowed from a sale or exchange of property (other than an interest in the partnership) directly or indirectly between a partnership and a person whose direct or indirect interest in the capital or profits of the partnership is more than 50%.

If the sale or exchange is between two partnerships in which the same persons directly or indirectly own more than 50% interest of the capital or profits in each partnership, no deduction of a loss is allowed.

The basis of each partner's interest in the partnership is decreased (but not below zero) by the partner's share of the disallowed loss.

If the purchaser later sells the property, only the gain realized greater than the loss not allowed will be taxable. If any gain from the sale of the property is not recognized because of this rule, the basis of each partner's interest in the partnership is increased by the partner's share of that gain.

Gains. Gains are treated as ordinary income in a sale or exchange of property directly or indirectly between a person and a partnership, or between two partnerships, if both of the following apply:

- 1) More than 50% of the capital or profits interest in the partnership(s) is directly or indirectly owned by the same person(s), and
- 2) The property in the hands of the transferee immediately after the transfer is not a capital asset. Property that is not a capital asset includes accounts receivable, inventory, stock-in-trade, and depreciable or real property used in a trade or business.

More than 50% ownership. To determine if there is more than 50% ownership in partnership capital or profits, the following rules apply.

- 1) An interest directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.
- 2) An individual is considered to own the interest directly or indirectly owned by or for the individual's family. For this rule, "family" includes only brothers, sisters, half-brothers, half-sisters, spouses, ancestors, and lineal descendants.
- 3) If a person is considered to own an interest using rule (1), that person (the "constructive owner") is treated as if actually owning that interest when rules (1) and (2) are applied. However, if a person is considered to own an interest using rule (2), that person is not treated as actually owning that interest in reapplying rule (2) to make another person the constructive owner.

Example. Individuals A and B and Trust T are equal partners in Partnership ABT. A's husband, AH, is the sole beneficiary of Trust T. Trust T's partnership interest will be attributed to AH only for the purpose of further attributing the interest to A. As a result, A is a more-than-50% partner. This means that any deduction for losses on transactions between her and ABT will not be allowed, and any gains will be treated as ordinary, rather than capital, gains.

More information. For more information on these special rules, see *Sales and Exchanges Between Related Parties* in chapter 2 of Publication 544.

Contribution of Property

Usually, neither the partners nor the partnership recognize a gain or loss when property is contributed to the partnership in exchange for a partnership interest. This applies whether a partnership is being formed or is already operating. The partnership's holding period for the property includes the partner's holding period.

The contribution of limited partnership interests in one partnership for limited partnership interests in another partnership qualifies as a tax-free contribution of property to the second partnership if the transaction is made for business purposes. The exchange is not subject to the rules explained later under *Disposition of Partner's Interest*.

Gain or loss recognized. A transaction may be treated as an exchange of property on which gain or loss is recognized if a partner contributes property to a partnership and within a short period:

- 1) Before or after the contribution, other property is distributed to the contributing partner and the contributed property is kept by the partnership, or
- 2) After the contribution, the contributed property is distributed to another partner.

Contribution to investment company.

Gain is recognized when property is contributed (in exchange for an interest in the partnership) to a partnership that would be treated as an investment company if it were incorporated. A loss realized on a contribution of stock, securities, or other property to a partnership is not recognized.

A partnership is treated as an investment company if over 80% of the value of its assets, excluding cash and nonconvertible debt obligations, is held for investment and consists of readily marketable stocks, securities, or interests in regulated investment companies or real estate investment trusts. Whether a partnership is an investment company under this test is ordinarily determined immediately after the transfer of property.

These rules apply to limited partnerships and general partnerships, regardless of whether they are privately formed or publicly syndicated.

Basis of contributed property. If a partner contributes property to a partnership, the partnership's basis for determining depreciation, depletion, and gain or loss for the property is the same as the partner's adjusted basis for the property when it was contributed, increased by any gain recognized by the partner at the time of contribution.

Allocations to account for built-in gain or loss. The fair market value of property at the time it is contributed may be different from the partner's adjusted basis. The partnership must allocate among the partners any income, deduction, gain, or loss on the property in a manner that will account for the difference. This rule also applies to contributions of accounts payable and other accrued but unpaid items of a cash basis partner.

The partnership can use different allocation methods for different items of contributed property. A single reasonable method must be consistently applied to each item, and the overall method or combination of methods must be reasonable. See Regulations section 1.704-3 for allocation methods generally considered reasonable.

If the partnership sells contributed property and recognizes gain or loss, built-in gain or loss is allocated to the contributing partner. If contributed property is subject to depreciation or other cost recovery, the allocation of deductions for these items takes into account built-in gain or loss on the property. However, the total depreciation, depletion, gain, or loss allocated to partners cannot be more than the depreciation or depletion allowable to the partnership or the gain or loss realized by the partnership.

Example. Sara and Gail form an equal partnership. Sara contributed \$10,000 in cash to the partnership and Gail contributed depreciable property with a fair market value of \$10,000 and an adjusted basis of \$4,000. The partnership's basis for depreciation is limited to the adjusted basis of the property in Gail's hands, \$4,000.

In effect, Sara purchased an undivided one-half interest in the depreciable property

with her contribution of \$10,000. Assuming that the depreciation rate is 10% a year under the General Depreciation System (GDS), she would have been entitled to a depreciation deduction of \$500 per year, based on her interest in the partnership.

However, since the partnership is allowed only \$400 per year of depreciation (10% of \$4,000), no more than \$400 can be allocated between the partners. The entire \$400 must be allocated to Sara.

Distribution of contributed property to another partner.

If a partner contributes property to a partnership and the partnership distributes the property to another partner within 5 years of the contribution, the contributing partner must recognize gain or loss on the distribution. The recognized gain or loss is the amount the contributing partner would have recognized if the property had been sold for its fair market value when it was distributed. The character of the gain or loss will be the same as the character that would have resulted if the partnership had sold the property to the distributee partner. Appropriate adjustments must be made to the adjusted basis of the contributing partner's partnership interest and to the adjusted basis of the property distributed to reflect the recognized gain or loss.

Disposition of certain contributed property. The following rules determine the character of the partnership's gain or loss on a later disposition of certain types of property.

- 1) **Unrealized receivables.** For property that was an unrealized receivable in the hands of the contributing partner, any gain or loss on a disposition by the partnership is ordinary income or loss. Unrealized receivables are defined later under *Payments for Unrealized Receivables and Inventory Items*. When reading the definition, substitute "partner" for "partnership."
- 2) **Inventory items.** For property that was an inventory item in the hands of the contributing partner, a gain or loss on a disposition by the partnership within 5 years after the contribution is ordinary income or loss. Inventory items are defined later in *Payments for Unrealized Receivables and Inventory Items*.
- 3) **Capital loss property.** For property that was a capital asset in the contributing partner's hands, any loss on a disposition by the partnership within 5 years after the contribution is a capital loss. The capital loss is limited to the amount by which the partner's adjusted basis for the property exceeded the property's fair market value immediately before the contribution.
- 4) **Substituted basis property.** If the partnership disposes of any of the above property in a nonrecognition transaction, these rules apply if the recipient of the property disposes of any substituted basis property resulting from the transaction.

Contribution of Services

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

Capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest. The fair market value of such an interest must generally be included in the partner's gross income in the first tax year in which the partner can transfer the interest or the interest is not subject to a substantial risk of forfeiture. The partnership interest transferred as compensation for services is subject to the rules discussed in chapter 2 of Publication 535 under *Payment in Restricted Property*.

The fair market value of an interest in partnership capital transferred to a partner as payment for services to the partnership is a guaranteed payment, discussed earlier.

Profits interest. A profits interest is a partnership interest other than a capital interest. If a person receives a profits interest for providing services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, the receipt of such an interest is not a taxable event for the partner or the partnership. However, this does not apply in the following situations.

- 1) The profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease.
- 2) Within 2 years of receipt, the partner disposes of the profits interest.
- 3) The profits interest is a limited partnership interest in a publicly traded partnership.

Basis of Partner's Interest

The basis of a partnership interest acquired by a contribution of property, including money, is the money a partner contributed plus the adjusted basis of any property he or she contributed. If the partner must recognize gain as a result of the contribution, this gain is included in the basis of his or her interest. Any increase in a partner's individual liabilities because of an assumption of partnership liabilities is considered a contribution of money to the partnership by the partner.

Interest acquired by gift, etc. If a partner acquires an interest in a partnership by gift, inheritance, or under any circumstance other than by a contribution of money or property to the partnership, the partner's basis must be determined using the basis rules described in Publication 551.

Adjusted Basis

The partner's basis is increased or decreased by the following items.

Increases. The basis of an interest in a partnership is increased by the partner's:

- 1) Additional contributions to the partnership, including an increased share of or assumption of partnership liabilities.
- 2) Distributive share of taxable and nontaxable partnership income.
- 3) Distributive share of the excess of the deductions for depletion over the basis of the depletable property.

Decreases. The partner's basis is decreased (but never below zero) by:

- 1) The money (including a decreased share of partnership liabilities or an assumption of the partner's individual liabilities by the partnership) and adjusted basis of property distributed to the partner by the partnership.
- 2) The partner's distributive share of the partnership losses (including capital losses).
- 3) The partner's distributive share of nondeductible partnership expenses that are not capital expenditures.
- 4) The partner's deduction for depletion for any partnership oil and gas wells, up to the proportionate share of the adjusted basis of the wells allocated to the partner.
- 5) The partner's share of any section 179 expenses, even if the partner cannot deduct the entire amount on his or her individual income tax return.

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

Example 1. John acquired a 20% interest in a partnership by contributing property that had an adjusted basis to him of \$8,000 and a \$4,000 mortgage. The partnership assumed payment of the mortgage. The basis of John's interest is:

Adjusted basis of contributed property	\$8,000
Minus: Part of mortgage assumed by other partners (80% × \$4,000)	<u>3,200</u>
Basis of John's partnership interest	<u>\$4,800</u>

Example 2. If, in the above example, the contributed property had a \$12,000 mortgage, the basis of John's partnership interest would be zero. The \$1,600 difference between the mortgage assumed by the other partners,

\$9,600 (80% × \$12,000), and his basis of \$8,000 would be treated as capital gain from the sale or exchange of a partnership interest. However, this gain **would not** increase the basis of his partnership interest.

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

Example. Sam contributes to his partnership property that has an adjusted basis of \$400 and a fair market value of \$1,000. His partner contributes \$1,000 cash. While each partner has increased his capital account by \$1,000, which will be reflected in the partnership books, the adjusted basis of Sam's interest is only \$400 and the adjusted basis of his partner's interest is \$1,000.

When determined. The adjusted basis of a partner's partnership interest is ordinarily determined at the end of the partnership's tax year. However, if there has been a sale or exchange of all or part of the partner's interest or a liquidation of his or her entire interest in a partnership, the adjusted basis is determined on the date of sale, exchange, or liquidation.

Alternative rule for figuring adjusted basis.

In certain cases, the adjusted basis of a partnership interest can be figured by using the partner's share of the adjusted basis of partnership property that would be distributed if the partnership terminated.

This alternative rule can be used if either of the following applies.

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

Adjustments may be necessary in figuring the adjusted basis of a partnership interest under the alternative rule. For example, adjustments would be required to include in the partner's share of the adjusted basis of partnership property any significant discrepancies that resulted from contributed property, transfers of partnership interests, or distributions of property to the partners.

Effect of Partnership Liabilities

A partner's basis in a cash basis partnership includes a partnership liability only if, and to the extent that, the liability:

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

The term "assets" in (1) above includes capitalized items allocable to future periods, such as organization expenses.

A partner's share of accrued but unpaid expenses or accounts payable of a cash basis partnership are not included in the adjusted basis of the partner's interest in the partnership.

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

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

Partner's share of liabilities. A partner's share of any partnership liability depends on whether the liability is a recourse or nonrecourse liability.

Recourse liability. A partnership liability is a recourse liability to the extent that any partner or related person has an economic risk of loss for that liability. A partner's share of such liability equals that partner's share of the economic risk of loss.

Nonrecourse liability. A partnership liability is a nonrecourse liability if no partner or related person has an economic risk of loss for that liability. A partner's share of such a liability is generally determined by the partner's ratio for sharing partnership profits.

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

- 1) He or she is personally liable for it, and
- 2) The creditor knows that the liability was assumed by the partner or a person related to the partner. The creditor must also be able to demand payment from the partner, and no other partner or person related to another partner may bear the economic risk of loss on that liability immediately after the assumption.

Related person. A related person, for these purposes, includes:

- 1) An individual and his or her spouse, ancestors, and lineal descendants.
- 2) An individual and a corporation 80% or more in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual.
- 3) Two corporations that are members of the same controlled group.
- 4) A grantor and a fiduciary of any trust.
- 5) Fiduciaries of two separate trusts if the same person is a grantor of both trusts.
- 6) A fiduciary and a beneficiary of the same trust.

- 7) A fiduciary and a beneficiary of two separate trusts if the same person is a grantor of both trusts.
- 8) A fiduciary of a trust and a corporation, 80% or more in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or a grantor of the trust.
- 9) A person and a tax-exempt educational or charitable organization controlled directly or indirectly by the person or by members of the person's family.
- 10) A corporation and a partnership if the same persons own 80% or more in value of the outstanding stock of the corporation and 80% or more of the capital or profits interest in the partnership.
- 11) Two S corporations or an S corporation and a C corporation if the same persons own 80% or more in value of the outstanding stock of each corporation.
- 12) A partnership and a person owning, directly or indirectly, 80% or more of the capital or profits interest in the partnership.
- 13) Two partnerships in which the same persons own, directly or indirectly, 80% or more of the capital or profits interests.

Economic risk of loss. A partner has an economic risk of loss if that partner or related person, defined earlier, would be obligated (whether by agreement or law) to make a net payment to the creditor or a contribution to the partnership with respect to the liability if the partnership were constructively liquidated. A partner who is the creditor for a liability that would otherwise be a nonrecourse liability of the partnership has an economic risk of loss in that liability.

Constructive liquidation. Generally, in a constructive liquidation, the following events are treated as occurring at the same time.

- 1) All partnership liabilities become payable in full.
- 2) All of the partnership's assets have a value of zero, except for property contributed to secure a liability.
- 3) All property is disposed of by the partnership in a fully taxable transaction for no consideration (except relief from liabilities for which the creditor's right to reimbursement is limited solely to one or more assets of the partnership).
- 4) All items of income, gain, loss, or deduction are allocated to the partners.
- 5) The partnership liquidates.

Example. Ted and Jane form a cash basis general partnership with cash contributions of \$20,000 each. Under the partnership agreement, they share all partnership profits and losses equally. They borrow \$60,000 and purchase depreciable business equipment. This debt is included in the partners' basis in the partnership because incurring it creates an

additional \$60,000 of basis in the partnership's depreciable property.

If neither partner has an economic risk of loss in the liability, it is a nonrecourse liability. Each partner's basis would include his or her share of the liability, \$30,000.

If Jane is required to pay the creditor if the partnership defaults, she has an economic risk of loss in the liability. Her basis in the partnership would be \$80,000 (\$20,000 + \$60,000), while Ted's basis would be \$20,000.

Limited partner. A limited partner generally has no obligation to contribute additional capital to the partnership and therefore does not have an economic risk of loss in partnership liabilities.

More information. For more information on the effect of partnership liabilities, including rules for limited partners and examples, see sections 1.752-1 through 1.752-5 of the Income Tax Regulations.

Disposition of Partner's Interest

The following discussions explain the treatment of gain or loss from the disposition of an interest in a partnership.

Abandoned or worthless partnership interest. A loss incurred from the abandonment or worthlessness of a partnership interest is an ordinary loss only if:

- 1) The transaction is not a sale or exchange, and
- 2) The partner has not received an actual or deemed distribution from the partnership.

If the partner receives even a de minimis actual or deemed distribution, the entire loss is a capital loss.

Sale, Exchange, or Other Transfer

The sale or exchange of a partner's interest in a partnership usually results in capital gain or loss. However, see *Payments for Unrealized Receivables and Inventory Items*, later, for certain exceptions. Gain or loss is the difference between the amount realized and the adjusted basis of the partner's interest in the partnership. If the selling partner is relieved of any partnership liabilities, that partner must include the liability relief as part of the amount realized for his or her interest.

Example 1. Fred became a limited partner in the ABC Partnership by contributing \$10,000 in cash on the formation of the partnership. The adjusted basis of his partnership interest at the end of the current year is \$20,000, which includes his \$15,000 share of partnership liabilities. The partnership has no unrealized receivables or substantially appreciated inventory items. Fred sells his interest in the partnership for \$10,000 in cash. He had been paid his share of the partnership income for the tax year.

Fred realizes \$25,000 from the sale of his partnership interest (\$10,000 cash payment + \$15,000 liability relief). He reports \$5,000 (\$25,000 realized - \$20,000 basis) as a capital gain.

Example 2. The facts are the same as Example 1, except that Fred withdraws from the partnership when the adjusted basis of his interest in the partnership is zero. He is considered to have received a distribution of \$15,000, his relief of liability. He reports a capital gain of \$15,000.

Partnership election to adjust basis of partnership property. Generally, a partnership's basis in its assets is not affected by a transfer of an interest in the partnership, whether by sale or exchange or because of the death of a partner. However, the partnership can elect to make an optional adjustment to basis in the year of transfer. See *Adjusting the Basis of Partnership Property*, later, for information on making the election.

Exchange of partnership interests. An exchange of partnership interests generally does not qualify as a nontaxable exchange of like-kind property. This applies regardless of whether they are general or limited partnership interests or interests in the same or different partnerships. However, under certain circumstances, such an exchange may be treated as a tax-free contribution of property to a partnership. See *Contribution of Property*, earlier.

An interest in a partnership that has a valid election in effect under section 761(a) of the Internal Revenue Code to be excluded from the partnership rules of the Code is treated as an interest in each of the partnership assets and not as a partnership interest. See *Exclusion From Partnership Rules*, earlier.

Installment reporting for sale of partnership interest. A partner who sells a partnership interest at a gain may be able to report the sale on the installment method. For requirements and other information on an installment sale, see Publication 537, *Installment Sales*.

The gain from the installment sale is treated as part capital gain and part ordinary income if the partnership's assets included unrealized receivables and substantially appreciated inventory items. See *Payments for Unrealized Receivables and Inventory Items*, later.

An allocation must be made to ensure that the income is correctly reported. The gain allocated to unrealized receivables and substantially appreciated inventory items is generally ordinary income and must be reported in the year of sale. The gain allocated to the other assets is capital gain and can be reported under the installment method.

Liquidation at Partner's Retirement or Death

Payments made by the partnership to a retiring partner or successor in interest of a deceased partner in return for the partner's entire interest in the partnership may have to be

allocated between payments in liquidation of the partner's interest in partnership property and other payments.

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

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

Unrealized receivables and goodwill.

Payments in exchange for an interest in partnership property do not include amounts paid for:

- 1) Unrealized receivables of the partnership, or
- 2) Goodwill of the partnership, except to the extent the partnership agreement provides for a payment for goodwill.

Unrealized receivables are defined in *Payments for Unrealized Receivables and Inventory Items*, next. However, for this purpose, unrealized receivables do not include the *Other items treated as unrealized receivables* listed in that discussion.

This rule about unrealized receivables and goodwill of the partnership applies to partners retiring or dying on or after January 5, 1993 (unless a written contract to purchase the retiring partner's interest in the partnership was binding on January 4, 1993, and at all times thereafter), only if:

- 1) Capital is not a material income-producing factor for the partnership, and
- 2) The retiring or deceased partner was a general partner in the partnership.

If the partner was not a general partner or if capital is a material income-producing factor, the partnership will not receive a deduction or its equivalent (distributive share) for the payments.

Capital is not a material income-producing factor if substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by a partner or the partnership's employees. The practice of his or her profession by a physician, dentist, lawyer, architect, or accountant is treated as a trade or business in which capital is not a material income-producing factor. This rule applies even though the practitioner may have a substantial capital investment in the professional equipment or physical plant of the practice, so long as the capital investment is merely incidental to the professional practice.

Partners' valuation. Generally, the partners' valuation of a partner's interest in partnership property in an arm's-length agreement will be treated as correct. If the valuation reflects only the partner's net interest in the property (total assets less liabilities), it must be

adjusted so that both the value of and the basis for the partner's interest include the partner's share of partnership liabilities.

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

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

If the amount is based on partnership income, the payment is taxable as a distributive share of partnership income. The payment retains the same character when reported by the recipient that it would have had if reported by the partnership. For more information, see *Partner's Distributive Share*, earlier, and *Distributive Share in Year of Disposition*, later.

If the amount is not based on partnership income, it is treated as a guaranteed payment. The recipient reports guaranteed payments as ordinary income. For additional information on guaranteed payments, see *Transactions Between Partnership and Partners*, earlier.

These payments are included in income by the recipient for his or her tax year that includes the end of the partnership tax year for which the payments are a distributive share or in which the partnership is entitled to deduct them as guaranteed payments.

Former partners who continue to make guaranteed periodic payments to satisfy the partnership's liability to a retired partner after the partnership is terminated can deduct the payments as a business expense in the year paid.

Payments for Unrealized Receivables and Inventory Items

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

This treatment applies to the unrealized receivables part of payments to a retiring partner or successor in interest of a deceased partner only if that part is not treated as paid in exchange for partnership property. See *Payments in liquidation of interest in partnership property* earlier.

Unrealized receivables. Unrealized receivables are any rights to payment not already included in income for:

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

These rights must have arisen under a contract or agreement that existed at the time of sale or distribution, even though the partnership may not be able to enforce payment until a later date. For example, unrealized receivables include accounts receivable of a cash method partnership and rights to payment for work or goods begun but incomplete at the time of the sale or distribution of the partner's share.

The basis for any unrealized receivables includes all costs or expenses for the receivables that were paid or accrued but not previously taken into account under the partnership's method of accounting.

Other items treated as unrealized receivables. Unrealized receivables include potential gain that would be ordinary income if the following partnership property were sold at its fair market value on the date of the payment:

- 1) Mining property for which exploration expenses were deducted.
- 2) Stock in a Domestic International Sales Corporation (DISC).
- 3) Certain farm land for which expenses for soil and water conservation or land clearing were deducted.
- 4) Franchises, trademarks, or trade names.
- 5) Oil, gas, or geothermal property for which intangible drilling and development costs were deducted.
- 6) Stock of certain controlled foreign corporations.
- 7) Market discount bonds and short-term obligations.
- 8) Property subject to recapture of depreciation under sections 1245 and 1250 of the Internal Revenue Code. Depreciation recapture is discussed in chapter 4 of Publication 544.

Determining value. Generally, any arm's-length agreement between the buyer and the seller (or between the partnership and the partner receiving the distribution) will establish the amount or value of:

- 1) The sales price of unrealized receivables, or
- 2) The value of the receivables received in a distribution treated as a sale or exchange.

If no agreement exists, an allowance must be made for the estimated cost to complete performance of the contract or agreement, and for the time between the sale or distribution and the time of payment.

Example. You are a partner in ABC Partnership. The adjusted basis of your partnership interest at the end of the current year is zero. Your share of potential ordinary income from partnership depreciable property is \$5,000. The partnership has no other unrealized receivables or substantially appreciated inventory items. You sell your interest in the partnership for \$10,000 in cash and you report the entire amount as a gain since your adjusted basis in the partnership is zero. You report as ordinary income your \$5,000 share of potential ordinary income from the partnership's depreciable property. The remaining \$5,000 gain is a capital gain.

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

Items included as inventory. Inventory items are not just stock-in-trade of the partnership. They include inventory on hand at the end of the tax year or held primarily for sale to customers in the normal course of business. They include any asset which, if sold or exchanged by the partnership, would not be a capital asset or section 1231 property (real or depreciable business property held more than one year). For example, accounts receivable acquired for services or from the sale of inventory and unrealized receivables are inventory items. Inventory items also include any other property held by the partnership that would be considered inventory if held by the selling or distributee partner.

Example. Assume that you sell your one-third interest in your partnership. The partnership uses an accrual method of accounting, has no liabilities, and has the following assets:

Assets	Adjusted Basis	Fair Market Value
Cash	\$ 10,000	\$ 10,000
Accounts receivable	5,000	2,500
Trade notes receivable	2,000	2,100
Merchandise on hand	4,000	9,500
Land	80,000	100,000
Total assets	\$ 101,000	\$ 124,100

The inventory items—the accounts receivable, trade notes receivable, and merchandise—have a total adjusted basis of \$11,000 and a fair market value of \$14,100. The total value of all assets other than cash is \$114,100. Because the fair market value of the inventory items (\$14,100) is more than 120% of their adjusted basis (\$11,000), the partnership has substantially appreciated inventory items. The amount you receive for your interest in the inventory items that exceeds your basis in them is ordinary income.

Notification of partnership. If a partner exchanges a partnership interest attributable to unrealized receivables or substantially appreciated inventory items for money or property, he or she must notify the partnership in writing. This must be done within 30 days of the transaction or, if earlier, by January 15 of the calendar year following the calendar year of the exchange.

Information return required of partnership. When a partnership is notified of an exchange of partnership interests involving unrealized receivables or substantially appreciated inventory items, the partnership must file Form 8308, *Report of a Sale or Exchange of Certain Partnership Interests*. Form 8308 is filed with Form 1065 for the tax year that includes the last day of the calendar year in which the exchange took place. If notified of an exchange after filing Form 1065, the partnership must file Form 8308 separately, within 30 days of the notification.

On Form 8308, the partnership states the date of the exchange and the names, addresses, and taxpayer identification numbers of the partnership filing the return and the transferee and transferor in the exchange. The partnership must also provide a copy of Form 8308 (or a written statement with the same information) to each transferee and transferor by the later of January 31 following the end of the calendar year or 30 days after it receives notice of the exchange.

Penalties. There is a penalty of up to \$50 for each failure to timely file or include complete and correct information on a required information return, up to a maximum of \$250,000 for any calendar year. The penalty may be reduced if the failure is corrected within specified time periods. If the average annual gross receipts of the partnership for the 3 tax years prior to the current year are \$5 million or less, the maximum penalty is \$100,000. If the failure to file or include complete and correct information is intentional, the penalty can be more.

There is a penalty of \$50 for each failure to furnish a statement to a transferor or transferee, up to a maximum of \$100,000 for any calendar year.

A partner will be subject to a penalty of \$50 for each failure to notify the partnership of an exchange of a partnership interest attributable to unrealized receivables or substantially appreciated inventory items, up to a maximum of \$100,000 for any calendar year.

These penalties will not apply if the partnership can show the failure was due to reasonable cause and not willful neglect.

For detailed guidance on penalties for failure to comply with the information reporting requirements, see Regulations sections 301.6721–1 through 301.6724–1.

Statement required of partner. If a partner sells or exchanges any part of an interest in a partnership having unrealized receivables or substantially appreciated inventory items, he or she must file a statement with his or her tax

return for the year in which the sale or exchange occurs. The statement must contain the following information.

- 1) The date of the sale or exchange, the partner's adjusted basis for the partnership interest, and the part of the basis that represents unrealized receivables or substantially appreciated inventory items.
- 2) The money and fair market value of any other property the partner received or will receive for the interest in the partnership, and the part for unrealized receivables or substantially appreciated inventory items.
- 3) The statement described earlier in *Special adjustment to basis of property received under Partner's Basis for Distributed Property*, if the partner computes the basis for the unrealized receivables or substantially appreciated inventory items under that provision.
- 4) If the partnership used the optional basis adjustment, the computation described later under *Adjusting the Basis of Partnership Property* and a list of the partnership properties to which the adjustment has been allocated.

Partner's disposition of distributed unrealized receivables or inventory items. In general, any gain or loss on a sale or exchange of unrealized receivables or inventory items a partner receives in a distribution is an ordinary gain or loss. For this purpose, inventory items do not include real or depreciable business property, even if they are not held more than 1 year.

Exception for inventory items held more than 5 years. If a distributee partner sells inventory items held for more than 5 years after the distribution, the type of gain or loss depends on how they are being used on the date sold. The gain or loss is capital gain or loss if the property is a capital asset in the partner's hands at the time sold.

Example 1. Ann receives, through dissolution, inventory that has a basis of \$19,000. Within 5 years, she sells the inventory for \$24,000. The \$5,000 gain is taxed as ordinary income. If she had held the inventory for more than 5 years, her gain would have been capital gain, provided the inventory was a capital asset in her hands at the time of sale.

Example 2. Mike, a distributee partner, received his share of accounts receivable when his law firm dissolved. The partnership used the cash method of accounting, so the receivables had a basis of zero to Mike. If the receivables are later collected, or if Mike sells them, the amount received will be ordinary income. The 5-year rule, illustrated in Example 1, does not apply to accounts receivable.

Substituted basis property. If a distributee partner disposes of unrealized receivables or inventory items in a nonrecognition transaction, ordinary gain or loss treatment applies to a later disposition of any substituted basis property resulting from the transaction.

Distributive Share in Year of Disposition

If a partner disposes of his or her entire interest in a partnership, the partner must include his or her distributive share of partnership items in income for the tax year in which membership in the partnership ends. To compute the distributive share of these items, the partnership's tax year is considered ended on the date the partner disposed of the interest. To avoid an interim closing of the partnership books, the partners can agree to estimate the distributive share by taking the prorated amount the partner would have included in income if he or she had remained a partner for the entire partnership tax year.

A partner who sells or exchanges only part of an interest in a partnership, or whose interest is reduced (whether by entry of a new partner, partial liquidation of a partner's interest, gift, or otherwise), reports his or her distributive share of partnership items by taking into account his or her varying interests during the partnership year.

Example. ABC is a calendar year partnership with three partners, Alan, Bob, and Cathy. Under the partnership agreement, profits and losses are shared in proportion to each partner's contributions. On January 1 the ratio was 90% for Alan, 5% for Bob, and 5% for Cathy. On December 1 Bob and Cathy each contributed additional amounts. The new profit and loss sharing ratios were 30% for Alan, 35% for Bob, and 35% for Cathy. For its tax year ended December 31, the partnership had a loss of \$1,200. This loss occurred equally over the partnership's tax year. The loss is divided among the partners as follows:

Partner	Profit or Loss	Part of Year Held	Share Total Loss =	Share of Loss
	% ×	1/12 ×	Loss =	Loss
Alan.....	90 ×	11/12 ×	\$1,200 =	\$990
	30 ×	1/12 ×	1,200 =	30
Bob	5 ×	11/12 ×	1,200 =	55
	35 ×	1/12 ×	1,200 =	35
Cathy ...	5 ×	11/12 ×	1,200 =	55
	35 ×	1/12 ×	1,200 =	35

Certain cash basis items prorated daily. If any partner's interest in a partnership changes during the tax year, each partner's share of certain cash basis items of the partnership must be determined by prorating the items on a daily basis. That daily portion is then allocated to the partners in proportion to their interests in the partnership at the close of each day. This rule applies to the following items for which the partnership uses the cash method of accounting.

- 1) Interest.
- 2) Taxes.
- 3) Payments for services or for the use of property.

Deceased partner. If a partner dies, the partner's estate or other successor in interest reports on its return the decedent's distributive share of the partnership items for the partnership year ending after the death occurred.

For example, if the partnership and the partners all use the calendar year as their tax year and one of the partners dies on June 10, none of the income of the partnership for that year will be reported on the final return of the deceased partner. All of it will be included on the return of the partner's estate or other successor in interest.

However, if the partnership terminates with the death of a partner, the partnership year closes for all partners. The deceased partner's share of income for that year will be included in the deceased partner's final return. If the decedent's tax year is different from the partnership's, the decedent's final return will include his or her share of partnership items for the partnership year ending with the decedent's death and any partnership year ending earlier in the decedent's last tax year.

Self-employment income. A different rule applies in computing a deceased partner's self-employment income. Self-employment income of a partner includes the partner's distributive share of income earned by the partnership through the end of the month in which the partner's death occurs. This is true even though the deceased partner's estate or heirs may succeed to the decedent's rights in the partnership. For this purpose, partnership income for the year in which a partner dies is considered to be earned equally in each month.

Example. Larry, a partner in WoodsPar, is a calendar year taxpayer. WoodsPar's fiscal year ends June 30. For the partnership year ending June 30, 1996, Larry's distributive share of partnership profits is \$2,000. On August 18, 1996, Larry dies. For the partnership year ending June 30, 1997, Larry and his estate's distributive share is \$3,000.

Larry's self-employment income to be reported on Schedule SE (Form 1040) for 1996 is \$2,500. This consists of his \$2,000 distributive share for the partnership tax year ending June 30, 1996, plus \$500 ($\frac{7}{12} \times \$3,000$) of the distributive share for the tax year ending June 30, 1997.

However, Larry's partnership income to be reported on Form 1040 for 1996 is \$2,000. This is because his final return includes only his share of partnership income for the partnership year that ended within his last tax year.

Adjusting the Basis of Partnership Property

Generally, a partnership cannot adjust the basis of its property because of a distribution of property to a partner or because of a transfer of an interest in the partnership, whether by sale or exchange or because of the death of a partner. The partnership can adjust the basis only if it files an election to make an optional adjustment to the basis of its property upon the distribution or transfer. A partnership does

not adjust the basis of partnership property for a contribution of property, including money, to the partnership.

Distributions. When there is a distribution of partnership property to a partner, the partnership makes the optional adjustment by:

- 1) Increasing the adjusted basis of the retained partnership property by:
 - a) Any gain recognized by the distributee partner on the distribution, plus
 - b) The excess, if any, of the partnership's adjusted basis for the distributed property (immediately before the distribution) over the basis of the property to the distributee, **or**
- 2) Decreasing the adjusted basis of the retained partnership property by:
 - a) Any loss recognized by the distributee partner on the distribution, plus
 - b) The excess, if any, of the distributee partner's basis for the distributed property over the partnership's adjusted basis for the property (immediately before the distribution).

Timing of adjustment. If a partnership completely liquidates the interest of a partner by making a series of cash payments treated as distributions of the partner's interest in partnership property, the basis adjustments to partnership property must correspond in timing and amount with the recognition of gain or loss by the retiring partner, or a deceased partner's successor in interest, with respect to those payments.

Example. Alan owns a one-third interest in the partnership Sylvan Associates. Sylvan has an optional adjustment to basis election in effect. When Alan retires, Sylvan continues without dissolution and agrees to liquidate Alan's one-third interest in the partnership property by making a series of cash payments to Alan that are treated as distributions. The total amount of payments Alan will receive is fixed and exceeds the adjusted basis of Alan's interest in the partnership.

Sylvan increases the adjusted basis of its property by Alan's recognized gain in each partnership tax year during which Alan recognizes gain with respect to the payments.

Transfers. When there is a transfer of partnership interest because of a sale or exchange or a partner's death, the partnership makes the optional adjustment by:

- 1) Increasing the adjusted basis of the partnership property by:
 - a) The excess of the transferee's basis for his or her partnership interest, over
 - b) The transferee's share of the adjusted basis of all partnership property, **or**
- 2) Decreasing the adjusted basis of partnership property by:
 - a) The excess of the transferee partner's share of the adjusted basis of all partnership property, over

- b) The transferee's basis for his or her partnership interest.

These adjustments affect the basis of partnership property for the transferee partner only. They become part of his or her share of the common partnership basis.

Making the election. The optional adjustment to basis is made by filing a written statement with Form 1065 for the tax year in which the distribution or transfer occurs. For the election to be valid, the return must be filed on time, including extensions. The statement must include the name and address of the partnership, be signed by one of the partners, and state that the partnership elects under section 754 to apply sections 734(b) and 743(b) of the Internal Revenue Code. Once a valid election has been made, it applies in succeeding years until it is revoked.

If the election cannot be made with the return, a partner or the partnership can request an automatic extension of 12 months to make the election. See Revenue Procedure 92-85 for more information.

Revoking the election. The election can be revoked only with the approval of the IRS. An application to revoke the election must be filed with the director for the district in which the partnership return must be filed. This application must be filed within 30 days after the close of the partnership tax year for which the change is to be effective. The application must be signed by one of the partners and state why the partnership wishes to revoke the election.

Examples of sufficient grounds for approving the application include:

- 1) A change in the nature of the business.
- 2) A substantial increase in assets.
- 3) A change in the character of the assets.
- 4) An increased frequency of retirements or shifts of partnership interests.

However, the IRS will not approve an application to revoke the election if its primary purpose is to avoid decreasing the basis of partnership assets upon a transfer or distribution.

Form 1065 Example

This filled-in Form 1065 is for the AbleBaker Book Store, a partnership composed of Frank Able and Susan Baker. The partnership uses an accrual method of accounting and a calendar year for reporting income and loss. Frank works full time in the business, while Susan works approximately 25% of her time in it. Both partners are general partners.

The partnership agreement states that Frank will receive a yearly guaranteed payment of \$20,000 and Susan will receive \$5,000. Any profit or loss will be shared equally by the partners. The partners are personally liable for all partnership liabilities. Both partners materially participate in the operation of the business.

In addition to income and expenses from partnership operations, AbleBaker made a \$650 cash charitable contribution, received \$150 from dividends, and received \$50 tax-exempt interest from municipal bonds.

Each partner's distributive share of specially allocated items should be shown on the appropriate line of the partner's Schedule K-1 and the total amount on Schedule K, instead of on page 1, Form 1065 or Schedule A or D.

Frank completes the partnership's Form 1065 as explained next.

Page 1

The IRS sent Frank a postcard with his pre-addressed label asking if he needed a Form 1065 package. He returned the postcard and the IRS sent him the package. When Frank completes the return, he places the label in the address area on page 1.

Frank supplies all the information requested at the top of the page.

Income

The partnership's ordinary income (loss) from the trade or business activity is shown on lines 1a through 8.

Line 1. Gross sales of \$409,465 are entered on line 1a. Returns and allowances of \$3,365 are entered on line 1b, resulting in net sales of \$406,100, entered on line 1c.

Line 2. Cost of goods sold, \$267,641, from Schedule A, line 8, is entered here.

Line 3. Gross profit of \$138,459 is shown on this line.

Line 7. Interest income on accounts receivable, \$559, is entered on this line. The schedule that must be attached for this line is not shown.

Line 8. Total income, \$139,018 (lines 3 through 7), is shown on line 8.

Deductions

The partnership's allowable deductions are shown on lines 9 through 21.

Line 9. All salaries and wages are included on line 9, except guaranteed payments to partners (shown on line 10). Frank lists \$29,350 on line 9. The partnership had no employment credits to reduce that amount.

Line 10. Guaranteed payments of \$25,000 to partners Frank (\$20,000) and Susan (\$5,000) are entered here.

Line 11. Repairs of \$1,125 made to partnership equipment are entered on this line.

Line 12. During the year, \$250 owed to the partnership was determined to be a wholly worthless business bad debt. The \$250 is shown on line 12. If this had been a nonbusiness bad debt, it would be included in the partnership's separately stated short-term capital loss.

Line 13. Rent paid for the business premises, \$20,000, is listed on this line.

Line 14. Deductible taxes of \$3,295 are entered on this line.

Line 15. Interest paid to suppliers during the year totaled \$1,451. This is business interest, so it is entered on line 15. Interest paid to a partner that is not a guaranteed payment is also included on this line.

Lines 16a and 16c. Depreciation of \$1,174 claimed on assets used in a trade or business is entered on these lines. Line 16b is for depreciation listed elsewhere on the return. Form 4562 is not shown in this example.

Line 20. Other allowable deductions of \$8,003 not listed elsewhere on the return and for which a separate line is not provided on page 1 are included on this line. Frank attaches a schedule that lists each deduction and the amount included on line 20. This schedule is not shown.

Line 21. The total of all deductions, \$89,648 (lines 9 through 20), is entered on this line.

Line 22. The amount on line 21 is subtracted from the amount on line 8. The result, \$49,370, is entered on line 22 of page 1 and on line 1 of Schedule K. The amount allocated to each partner is listed on line 1 of Schedule K-1.

Signatures

Frank signs the return as a general partner. The AbleBaker Book Store did not have a paid preparer.

Page 2 Schedule A

Schedule A shows the computation of cost of goods sold. Beginning inventory, \$18,125, is entered on line 1 and net purchases, \$268,741, are entered on line 2. The total, \$286,866, is entered on line 6. Ending inventory, \$19,225 (entered on line 7), is subtracted from line 6 to arrive at cost of goods sold, \$267,641 (entered on line 8 and on page 1, line 2).

Frank answers all applicable questions for item 9.

Schedule B

Schedule B contains 11 questions about the partnership. Frank answers question 1 by marking the "General partnership" box. He answers questions 2 through 11 by marking the "No" boxes.

Question 5 asks if the partnership meets all the requirements listed in items 5a, b, and c. Because the partnership's total receipts were not less than \$250,000, all three of these requirements are not met. Frank must complete Schedules L, M-1, M-2, and item F on page 1 of Form 1065 and item J on Schedule K-1.

Page 3 Schedule K

Schedule K lists the total of all partners' shares of income, deductions, credits, etc. Each partner's distributive share of income, deductions, credits, etc., is reported on Schedule K-1. The line items for Schedule K are discussed in combination with the Schedule K-1 line items, later.

Page 4 Schedules L, M-1, and M-2

Partnerships do not have to complete Schedules L, M-1, or M-2 if all of the tests listed

under question 5 of Schedule B are met and question 5 is marked "Yes." The AbleBaker Book Store does not meet all of the tests, so these schedules must be completed.

Schedule L

Schedule L contains the partnership's balance sheets at the beginning and end of the tax year. All information shown on the balance sheets for the AbleBaker Book Store should agree with its books of record.

The entry in column (d) of line 14 for total assets at the end of the year, \$45,391, is carried to item F at the top of page 1 since the answer to question 5 on Schedule B was "No."

Schedule M-1

Schedule M-1 is the reconciliation of income per the partnership books with income per Form 1065.

Line 1. This line shows the net income per books of \$48,920. This amount is from the profit and loss account (not shown in this example).

Line 3. This line shows the guaranteed payments to partners.

Line 5. This is the total of lines 1 through 4 of \$73,920.

Line 6. Included in line 6 is the \$50 tax-exempt interest income from municipal bonds recorded on the books but not included on Schedule K, lines 1 through 7. Each partner's share of this interest is reported on his or her Schedule K-1 on line 19.

Line 9. This is line 5 less line 8, \$73,870. This line is the same as Schedule K, line 25a.

Schedule M-2

Schedule M-2 is an analysis of the partners' capital accounts. It shows the total equity of all partners at the beginning and end of the tax year and the adjustments that caused any increase or decrease. The total of all the partners' capital accounts is the difference between the partnership's assets and liabilities shown on Schedule L. A partner's capital account does not necessarily represent the tax basis for an interest in the partnership.

Line 1. As of January 1, the total of the partners' capital accounts was \$27,550 (Frank — \$14,050; Susan — \$13,500). This amount should agree with the beginning balance shown on line 21 of Schedule L for the partners' capital accounts.

Line 3. This is the net income per books.

Line 5. This is the total of lines 1 through 4.

Line 6. Each partner withdrew \$26,440 (totaling \$52,880) from the partnership. These withdrawals are shown here and on Schedule K, line 22. The partners' guaranteed payments, which were actually paid, are not included because they were deducted when figuring the amount shown on line 3.

Line 9. This shows the total equity of all partners as shown in the books of record as of December 31. This amount should agree with the year-end balance shown on line 21 of Schedule L for the partners' capital accounts.

Item J on Schedule K-1 reflects each partner's share of the amounts shown on lines 1 through 9 of Schedule M-2.

Schedule K-1

Schedule K-1 lists each partner's share of income, deductions, credits, etc. It also shows where to report the items on the partner's individual income tax return. Illustrated is a copy of the Schedule K-1 for Frank W. Able. All information asked for at the top of Schedule K-1 must be supplied for each partner.

Allocation of Partnership Items

The partners' shares of income, deductions, etc., are shown next.

Income (Loss)

Line 1. This line on Schedule K-1 shows Frank's share (\$24,685) of the income from the partnership shown on Form 1065, page 1, line 22. The total amount of income to both partners is shown on line 1, Schedule K.

Line 4b. Dividends must be separately stated. They are not included in the income (loss) of the partnership on Form 1065, page 1, line 22. This line on Schedule K-1 shows Frank's share, \$75. This line on Schedule K shows the total dividends of \$150.

Line 5. This line on Schedule K-1 shows only the guaranteed payments to Frank of \$20,000. This line on Schedule K shows the total guaranteed payments to both partners of \$25,000.

Deductions

Line 8. During the year, the partnership made a \$650 cash contribution to the American Lung Association. Each partner can deduct all or part of his or her share of the partnership's charitable contribution on his or her individual income tax return if the partner itemizes deductions. Frank's share of the contribution, \$325, is entered on line 8, Schedule K-1. This line on Schedule K shows the total contribution.

Investment Interest

Lines 12a-12b. The partnership had investment income (dividends) of \$150 as shown on line 4b, Schedule K. This amount is shown on line 12b(1), Schedule K, and the partner's share is shown on line 12b(1), Schedule K-1.

Net Earnings From Self-Employment

Line 15a. Net earnings (loss) from self-employment are figured using the worksheet in the Form 1065 instructions for Schedule K (not shown). Frank and Susan's net earnings from self-employment are the total of the partnership income shown on line 1 of Schedule K and the guaranteed payments shown on line 5. This total, \$74,370, is entered on Schedule K, and each individual partner's share is shown on his or her Schedule K-1. Each partner uses his or her share to figure his or her self-employment tax on Schedule SE (Form 1040), *Self-Employment Tax* (not shown).

Tax-Exempt Interest Income

Line 19. Tax-exempt interest income, including any exempt-interest dividends received from a mutual fund or other regulated investment company, is entered here. Frank enters the \$50 municipal bond interest received by the partnership on Schedule K and \$25 on each partner's Schedule K-1.

Distributions

Line 22. Frank enters the \$52,880 cash withdrawals made by the partners during the year on Schedule K. He enters the amount each partner withdrew on the partner's Schedule K-1.

Analysis

Lines 25a-25b (Schedule K only). An analysis must be made of the distributive items on Schedule K. This analysis is based on the type of partner. Since the AbleBaker Book Store has two individual partners, both of whom are "active" general partners, the total, \$73,870, on line 25a is entered on line 25b(1), column (b)j.

How To Get More Information



You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office may also have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax services available from the IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you can also get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details. If space permitted, this information is at the end of this publication.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1-800-829-1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask tax questions or to order forms and publications. See your income tax package for details.

U.S. Partnership Return of Income

OMB No. 1545-0088

For calendar year 1996, or tax year beginning , 1996, and ending , 19

1996

A Principal business activity <i>Retail</i>	Use the IRS label. Otherwise, please print or type.	10-9876543	DEC96	D71	I R S	D Employer identification number
B Principal product or service <i>Books</i>		AbleBaker Book Store 334 West Main Street Orange, MD 20904				E Date business started <i>10-1-79</i>
C Business code number <i>5942</i>						F Total assets (see page 10 of the instructions) <i>\$ 45,391</i>

G Check applicable boxes: (1) Initial return (2) Final return (3) Change in address (4) Amended return

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

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

Caution: Include only trade or business income and expenses on lines 1a through 22 below. See the instructions for more information.

Income	1a Gross receipts or sales	1a	<i>409,465</i>		1c	<i>406,100</i>
	b Less returns and allowances	1b	<i>3,365</i>		1c	
	2 Cost of goods sold (Schedule A, line 8)	2	<i>267,641</i>			
	3 Gross profit. Subtract line 2 from line 1c.	3	<i>138,459</i>			
	4 Ordinary income (loss) from other partnerships, estates, and trusts (attach schedule)	4				
	5 Net farm profit (loss) (attach Schedule F (Form 1040))	5				
	6 Net gain (loss) from Form 4797, Part II, line 20.	6				
	7 Other income (loss) (attach schedule)	7		<i>559</i>		
8 Total income (loss). Combine lines 3 through 7	8		<i>139,018</i>			
Deductions (see page 11 of the instructions for limitations)	9 Salaries and wages (other than to partners) (less employment credits)	9	<i>29,350</i>			
	10 Guaranteed payments to partners	10	<i>25,000</i>			
	11 Repairs and maintenance	11	<i>1,125</i>			
	12 Bad debts	12	<i>250</i>			
	13 Rent	13	<i>20,000</i>			
	14 Taxes and licenses	14	<i>3,295</i>			
	15 Interest	15	<i>1,451</i>			
	16a Depreciation (if required, attach Form 4562)	16a	<i>1,174</i>		16c	<i>1,174</i>
	b Less depreciation reported on Schedule A and elsewhere on return	16b	<i>-0-</i>		16c	
	17 Depletion (Do not deduct oil and gas depletion.)	17				
	18 Retirement plans, etc.	18				
	19 Employee benefit programs	19				
	20 Other deductions (attach schedule)	20		<i>8,003</i>		
21 Total deductions. Add the amounts shown in the far right column for lines 9 through 20	21		<i>89,648</i>			
22 Ordinary income (loss) from trade or business activities. Subtract line 21 from line 8	22		<i>49,370</i>			

Please Sign Here

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

Frank H. Able *3-12-97*
Signature of general partner or limited liability company member Date

Paid Preparer's Use Only

Preparer's signature Date Check if self-employed Preparer's social security no. _____

Firm's name (or yours if self-employed) and address EIN ▶ _____ ZIP code ▶ _____

Schedule A Cost of Goods Sold (see page 13 of the instructions)

1	Inventory at beginning of year	1	18,125
2	Purchases less cost of items withdrawn for personal use	2	260,741
3	Cost of labor	3	-0-
4	Additional section 263A costs (attach schedule)	4	-0-
5	Other costs (attach schedule)	5	-0-
6	Total. Add lines 1 through 5	6	286,866
7	Inventory at end of year	7	19,225
8	Cost of goods sold. Subtract line 7 from line 6. Enter here and on page 1, line 2	8	267,641

9a Check all methods used for valuing closing inventory:

(i) Cost as described in Regulations section 1.471-3

(ii) Lower of cost or market as described in Regulations section 1.471-4

(iii) Other (specify method used and attach explanation) ▶

b Check this box if there was a writedown of "subnormal" goods as described in Regulations section 1.471-2(c).

c Check this box if the LIFO inventory method was adopted this tax year for any goods (if checked, attach Form 970)

d Do the rules of section 263A (for property produced or acquired for resale) apply to the partnership? . . . Yes No

e Was there any change in determining quantities, cost, or valuations between opening and closing inventory? Yes No
If "Yes," attach explanation.

Schedule B Other Information

	Yes	No
1 What type of entity is filing this return? Check the applicable box: a <input checked="" type="checkbox"/> General partnership b <input type="checkbox"/> Limited partnership c <input type="checkbox"/> Limited liability company d <input type="checkbox"/> Other (see page 14 of the instructions) ▶		
2 Are any partners in this partnership also partnerships?		✓
3 Is this partnership a partner in another partnership?		✓
4 Is this partnership subject to the consolidated audit procedures of sections 6221 through 6233? If "Yes," see Designation of Tax Matters Partner below		✓
5 Does this partnership meet ALL THREE of the following requirements? a The partnership's total receipts for the tax year were less than \$250,000; b The partnership's total assets at the end of the tax year were less than \$600,000; AND c Schedules K-1 are filed with the return and furnished to the partners on or before the due date (including extensions) for the partnership return. If "Yes," the partnership is not required to complete Schedules L, M-1, and M-2; Item F on page 1 of Form 1065; or Item J on Schedule K-1		✓
6 Does this partnership have any foreign partners?		✓
7 Is this partnership a publicly traded partnership as defined in section 469(k)(2)?		✓
8 Has this partnership filed, or is it required to file, Form 8264, Application for Registration of a Tax Shelter?		✓
9 At any time during calendar year 1996, did the partnership have an interest in or a signature or other authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)? See page 14 of the instructions for exceptions and filing requirements for Form TD F 90-22.1. If "Yes," enter the name of the foreign country. ▶		✓
10 During the tax year, did the partnership receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," see page 14 of the instructions for other forms the partnership may have to file		✓
11 Was there a distribution of property or a transfer (e.g., by sale or death) of a partnership interest during the tax year? If "Yes," you may elect to adjust the basis of the partnership's assets under section 754 by attaching the statement described under Elections Made By the Partnership on page 5 of the instructions		✓

Designation of Tax Matters Partner (see page 15 of the instructions)

Enter below the general partner designated as the tax matters partner (TMP) for the tax year of this return:

Name of designated TMP ▶ _____ Identifying number of TMP ▶ _____

Address of designated TMP ▶ _____

Schedule K		Partners' Shares of Income, Credits, Deductions, etc.							
		(a) Distributive share items		(b) Total amount					
Income (Loss)	1	Ordinary income (loss) from trade or business activities (page 1, line 22)		1	49,370				
	2	Net income (loss) from rental real estate activities (attach Form 8825)		2					
	3a	Gross income from other rental activities		3a					
		3b	Expenses from other rental activities (attach schedule)						
	3c	Net income (loss) from other rental activities. Subtract line 3b from line 3a		3c					
	4	Portfolio income (loss): a Interest income		4a					
		b Dividend income		4b	150				
c Royalty income		4c							
d Net short-term capital gain (loss) (attach Schedule D (Form 1065))		4d							
e Net long-term capital gain (loss) (attach Schedule D (Form 1065))		4e							
f Other portfolio income (loss) (attach schedule)		4f							
5	Guaranteed payments to partners		5	25,000					
6	Net gain (loss) under section 1231 (other than due to casualty or theft) (attach Form 4797)		6						
7	Other income (loss) (attach schedule)		7						
Deductions	8	Charitable contributions (attach schedule)		8	650				
	9	Section 179 expense deduction (attach Form 4562)		9					
	10	Deductions related to portfolio income (itemize)		10					
	11	Other deductions (attach schedule)		11					
Investment Interest	12a	Interest expense on investment debts		12a					
	12b	(1) Investment income included on lines 4a, 4b, 4c, and 4f above (2) Investment expenses included on line 10 above		12b(1) 12b(2)	150				
Credits	13a	Low-income housing credit:		13a					
		(1) From partnerships to which section 42(j)(5) applies for property placed in service before 1990		13a(1)					
		(2) Other than on line 13a(1) for property placed in service before 1990		13a(2)					
		(3) From partnerships to which section 42(j)(5) applies for property placed in service after 1989		13a(3)					
		(4) Other than on line 13a(3) for property placed in service after 1989		13a(4)					
	13b	Qualified rehabilitation expenditures related to rental real estate activities (attach Form 3468)		13b					
13c	Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities		13c						
13d	Credits related to other rental activities		13d						
14	Other credits		14						
Self-Employment	15a	Net earnings (loss) from self-employment		15a	74,370				
	15b	Gross farming or fishing income		15b					
	15c	Gross nonfarm income		15c					
Adjustments and Tax Preference Items	16a	Depreciation adjustment on property placed in service after 1986		16a					
	16b	Adjusted gain or loss		16b					
	16c	Depletion (other than oil and gas)		16c					
	16d	(1) Gross income from oil, gas, and geothermal properties (2) Deductions allocable to oil, gas, and geothermal properties		16d(1) 16d(2)					
	16e	Other adjustments and tax preference items (attach schedule)		16e					
Foreign Taxes	17a	Type of income ▶ Foreign country or U.S. possession ▶		17a					
	17b	Total gross income from sources outside the United States (attach schedule)		17b					
	17c	Total applicable deductions and losses (attach schedule)		17c					
	17d	Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued		17d					
	17e	Reduction in taxes available for credit (attach schedule)		17e					
	17f	Other foreign tax information (attach schedule)		17f					
	17g			17g					
Other	18a	Section 59(e)(2) expenditures: a Type ▶ b Amount ▶		18a					
	18b	Tax-exempt interest income		18b	50				
	19	Other tax-exempt income		19					
	20	Nondeductible expenses		20					
	21	Distributions of money (cash and marketable securities)		21					
	22	Distributions of property other than money		22	52,880				
23	Other items and amounts required to be reported separately to partners (attach schedule)		23						
Analysis	25a	Income (loss). Combine lines 1 through 7 in column (b). From the result, subtract the sum of lines 8 through 12a, 17e, and 18b				25a	73,870		
	b	Analysis by type of partner:	(a) Corporate	(b) Individual		(c) Partnership	(d) Exempt organization	(e) Nominee/Other	
				I. Active	II. Passive				
			(1) General partners		73,870				
			(2) Limited partners						

Note: If Question 5 of Schedule B is answered "Yes," the partnership is not required to complete Schedules L, M-1, and M-2.

Schedule L Balance Sheets per Books

Assets	Beginning of tax year		End of tax year	
	(a)	(b)	(c)	(d)
1 Cash		3,455		3,350
2a Trade notes and accounts receivable	7,150		10,990	
b Less allowance for bad debts		7,150		10,990
3 Inventories		18,125		19,225
4 U.S. government obligations				
5 Tax-exempt securities		1,000		1,000
6 Other current assets (attach schedule)				
7 Mortgage and real estate loans		1,000		1,000
8 Other investments (attach schedule)				
9a Buildings and other depreciable assets	15,000		15,000	
b Less accumulated depreciation	4,000	11,000	5,174	9,826
10a Depletable assets				
b Less accumulated depletion				
11 Land (net of any amortization)				
12a Intangible assets (amortizable only)				
b Less accumulated amortization				
13 Other assets (attach schedule)				
14 Total assets		41,730		45,391
Liabilities and Capital				
15 Accounts payable		10,180		10,462
16 Mortgages, notes, bonds payable in less than 1 year		4,000		3,600
17 Other current liabilities (attach schedule)				
18 All nonrecourse loans				
19 Mortgages, notes, bonds payable in 1 year or more				7,739
20 Other liabilities (attach schedule)				
21 Partners' capital accounts		27,550		23,590
22 Total liabilities and capital		41,730		45,391

Schedule M-1 Reconciliation of Income (Loss) per Books With Income (Loss) per Return
(see page 23 of the instructions)

1 Net income (loss) per books	48,920	6 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize):	
2 Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize):		a Tax-exempt interest \$	50
3 Guaranteed payments (other than health insurance)	25,000	7 Deductions included on Schedule K, lines 1 through 12a, 17e, and 18b, not charged against book income this year (itemize):	
4 Expenses recorded on books this year not included on Schedule K, lines 1 through 12a, 17e, and 18b (itemize):		a Depreciation \$	
a Depreciation \$		b Travel and entertainment \$	
b Travel and entertainment \$		8 Add lines 6 and 7	50
5 Add lines 1 through 4	73,920	9 Income (loss) (Schedule K, line 25a). Subtract line 8 from line 5	73,870

Schedule M-2 Analysis of Partners' Capital Accounts

1 Balance at beginning of year	27,550	6 Distributions: a Cash	52,880
2 Capital contributed during year		b Property	
3 Net income (loss) per books	48,920	7 Other decreases (itemize):	
4 Other increases (itemize):		a	
5 Add lines 1 through 4	76,470	8 Add lines 6 and 7	52,880
		9 Balance at end of year. Subtract line 8 from line 5	23,590

Ⓢ

SCHEDULE K-1
(Form 1065)

Partner's Share of Income, Credits, Deductions, etc.

OMB No. 1545-0099

1996

Department of the Treasury
Internal Revenue Service

For calendar year 1996 or tax year beginning

, 1992, and ending

, 19

▶ See separate instructions.

Partner's identifying number ▶ **123-00-6789**

Partnership's identifying number ▶ **10 : 9876543**

Partner's name, address, and ZIP code
Frank W. Able
10 Green Street
Orange, MD 20904

Partnership's name, address, and ZIP code
Able Baker Book Store
334 West Main Street
Orange, MD 20904

A This partner is a general partner limited partner
 limited liability company member

B What type of entity is this partner? ▶ **Individual**

C Is this partner a domestic or a foreign partner?

D Enter partner's percentage of:
Profit sharing % **50** %
Loss sharing % **50** %
Ownership of capital % **50** %

E IRS Center where partnership filed return: **Philadelphia**

F Partner's share of liabilities (see instructions):
Nonrecourse \$
Qualified nonrecourse financing \$
Other \$ **10,900**

G Tax shelter registration number ▶ **N/A**

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2)

I Check applicable boxes: (1) Final K-1 (2) Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
14,050		24,460	(26,440)	12,070

	(a) Distributive share item	(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1 Ordinary income (loss) from trade or business activities	24,685	See pages 5 and 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2 Net income (loss) from rental real estate activities		
	3 Net income (loss) from other rental activities		
	4 Portfolio income (loss):		Sch. B, Part I, line 1 Sch. B, Part II, line 5 Sch. E, Part I, line 4 Sch. D, line 5, col. (f) or (g) Sch. D, line 13, col. (f) or (g) Enter on applicable line of your return. See page 6 of Partner's Instructions for Schedule K-1 (Form 1065). Enter on applicable line of your return.
	a Interest		
	b Dividends	75	
	c Royalties		
d Net short-term capital gain (loss)			
e Net long-term capital gain (loss)			
f Other portfolio income (loss) (attach schedule)			
5 Guaranteed payments to partner	20,000	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).	
6 Net gain (loss) under section 1231 (other than due to casualty or theft)			
7 Other income (loss) (attach schedule)		Enter on applicable line of your return.	
Deductions	8 Charitable contributions (see instructions) (attach schedule)	325	Sch. A, line 15 or 16
	9 Section 179 expense deduction		See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
	10 Deductions related to portfolio income (attach schedule)		
	11 Other deductions (attach schedule)		
Investment Interest	12a Interest expense on investment debts		Form 4952, line 1
	b (1) investment income included on lines 4a, 4b, 4c, and 4f above (2) Investment expenses included on line 10 above	75	See page 7 of Partner's Instructions for Schedule K-1 (Form 1065).
Credits	13a Low-income housing credit: (1) From section 42(j)(5) partnerships for property placed in service before 1990 (2) Other than on line 13a(1) for property placed in service before 1990 (3) From section 42(j)(5) partnerships for property placed in service after 1989 (4) Other than on line 13a(3) for property placed in service after 1989		Form 8586, line 5
	b Qualified rehabilitation expenditures related to rental real estate activities		
	c Credits (other than credits shown on lines 13a and 13b) related to rental real estate activities		
	d Credits related to other rental activities		
	14 Other credits		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).

For Paperwork Reduction Act Notice, see instructions for Form 1065.

Cat. No. 11394R

Schedule K-1 (Form 1065) 1996

(a) Distributive share items		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Self-employment	15a Net earnings (loss) from self-employment	15a 44,685	Sch. SE, Section A or B See page 8 of Partner's instructions for Schedule K-1 (Form 1065).
	b Gross farming or fishing income	15b	
	c Gross nonfarm income	15c	
Adjustments and Tax Preference Items	16a Depreciation adjustment on property placed in service after 1986	16a	See pages 8 and 9 of Partner's instructions for Schedule K-1 (Form 1065) and instructions for Form 8261.
	b Adjusted gain or loss	16b	
	c Depletion (other than oil and gas)	16c	
	d (1) Gross income from oil, gas, and geothermal properties	d(1)	
	(2) Deductions allocable to oil, gas, and geothermal properties	d(2)	
e Other adjustments and tax preference items (attach schedule)	16e		
Foreign Taxes	17a Type of income ▶		Form 1116, check boxes
	b Name of foreign country or U.S. possession ▶		
	c Total gross income from sources outside the United States (attach schedule)	17c	Form 1116, Part I
	d Total applicable deductions and losses (attach schedule)	17d	
	e Total foreign taxes (check one): <input type="checkbox"/> Paid <input type="checkbox"/> Accrued	17e	Form 1116, Part II
	f Reduction in taxes available for credit (attach schedule)	17f	
	g Other foreign tax information (attach schedule)	17g	Form 1116, Part III See instructions for Form 1116.
Other	18 Section 59(e)(2) expenditures: a Type ▶		See page 9 of Partner's instructions for Schedule K-1 (Form 1065).
	b Amount	18b	
	19 Tax-exempt interest income	19 25	Form 1040, line 8b
	20 Other tax-exempt income	20	
	21 Nondeductible expenses	21	See page 9 of Partner's instructions for Schedule K-1 (Form 1065).
	22 Distributions of money (cash and marketable securities)	22 26,440	
	23 Distributions of property other than money	23	
	24 Recapture of low-income housing credit:		Form 8811, line 5
a From section 42(j)(5) partnerships	24a		
b Other than on line 24a	24b		
Supplemental Information	25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed):		
		
		
		
		
		
		
		
		
		
		
		
		
		
		



