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## **TRANSACTIONS BETWEEN PARTNERS AND PARTNERSHIPS**

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Transactions between partners and partnerships is a complex area of taxation which tends to generate much confusion. Below, some of the more common transactions are discussed to provide some insight to this continually growing form of business.

### **Partner Expenses Related to Partnership Business**

Partners often incur expenses related to the partnership's business that may or may not be reimbursed by the partnership. When expenses have not been reimbursed by the partnership, the question arises as to whether or not the partner may deduct those expenses on his or her tax return.

The answer to this depends on the partnership's reimbursement policy. Would the partnership have honored the reimbursement if it was requested? If the partnership has a reimbursement plan under the partnership agreement or firm policy, the partner may not deduct any of the expenses on their personal tax return. If the expense is one that the partner is expected to pay without reimbursement, the partner may deduct the expenses on Schedule E as unreimbursed partnership expenses. These expenses occur frequently in service partnerships where auto expenses and meals and entertainment expenses are incurred when developing client relationships.

### **Home Office**

A partner may deduct expenses that are allocable to the use of a home office if the space is regularly and exclusively used for partnership business. The normal deduction limitations under the home office rules apply to expenses such as depreciation, rent, mortgage interest, property taxes, insurance, utilities, maintenance and security which may be deducted to the extent they are allocable to the home office portion of the home.

In addition to being regularly and exclusively used for partnership business, one of the following tests must also be passed.

- 1) The home office is used as the partner's principal place for conducting business. This can be satisfied if:
  - a. Most of the partnership income-earning activities are conducted in the home office or
  - b. The home office is used to conduct partnership administrative and management tasks and there is not another fixed location where these tasks are conducted.
- 2) The home office is used as place where the partner meets or deals with clients or customers in the normal course of business.
- 3) The home office is a separate structure from the home and is used for partnership business.

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There are multiple tax-saving benefits when taking the home office deduction because the deduction is used for both federal income tax and self-employment tax purposes. Also, when the partner's home office passes the principal place of business test, commuting mileage from the home office to clients and the partnership's official office are considered to be business miles.

### **Guaranteed Payments**

A guaranteed payment is a payment made by the partnership to a partner acting in the capacity as a partner, in exchange for services performed for the partnership or for the use of capital by the partnership, and not dependent on partnership income. Sometimes these payments are considered "partner salaries" when they are made in exchange for services. However, for federal income tax withholding and employment tax purposes, partners are not considered employees.

A payment to a partner that is based on the *net income* of the partnership *IS NOT* a guaranteed payment. This payment would be considered a distribution of the partner's distributive share of net income. However, a payment based on the partnership *gross income* can be considered a guaranteed payment.

### **Tax Treatments**

The partnership either deducts or capitalizes the guaranteed payment depending on the nature of the payment. In most cases, the payment is deductible. However, the payment must be capitalized if, under general tax principles, it is a payment made for a capitalized expenditure.

A partner who receives a guaranteed payment reports the amount as ordinary income on his or her tax return. If the partnership conducts a trade or business, a guaranteed payment made to a partner in exchange for services provided to the partnership are included in their self-employment income. The partner is *NOT* considered an employee so they are not subject to withholding for federal income tax, Social Security tax, or Medicare tax.

Since guaranteed payments are not treated as distributions, there is no effect on the recipient partner's capital account or tax basis in the partnership interest. When a payment *IS* considered to be a distribution of the partner's share of income or capital, the recipient partner's interest in the partnership is reduced by the payment amount.

### **Fringe Benefits**

Payments made by the partnership for fringe benefits including health insurance premiums, HSA contributions, up to \$50,000 of group-term life insurance, and qualified transportation fringe benefits are considered guaranteed payments to the partner who receives the benefits if they provide services to the partnership.

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This means the partner reports the ordinary income and the partnership deducts the expense. In the case of health insurance premiums and HSA contributions, the partner may deduct the partnership-paid premiums and contributions as corresponding above-the-line deductions on his or her Form 1040. If the payments for fringe benefits are made for a partner who does not provide services, the payments are considered distributions to the partner and do not result in any taxable income to be reported by the partner or any deduction for the partnership.

#### **Loans vs. Capital Contributions**

When a partner advances cash to a partnership, the transaction can either be considered a loan or a contribution to capital. When considered a capital contribution, the partner's basis in the partnership interest is increased by the amount of the contribution. If the advance is considered a loan, the partner's basis in the partnership interest is increased by an amount equal to the partner's share of the liability under IRC Sec. 752 rules.

There are more tax consequences when the advance to the partnership creates a bona fide debt. In this case, the principal and interest payments are taxed the same as if the loan was between unrelated parties. This means the partner must report the interest income from the payments received from the partnership on his or her tax return. A written debt note should be drafted to establish a fixed repayment schedule and stated interest rate.

While the area of partnership taxation is complicated and sometimes counterintuitive the experts at Zinner & Co. LLP can assist you in making sound decisions based on your unique needs and goals. Your success is our business!