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Partnership Return of Income: Federal Form —1065

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The Partnership Return of Income

FEDERAL FORM—1065

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The procedure in preparing partnership returns has been considerably simplified in the 1934 law in comparison with previous years, yet there remain a few points which are still open to controversy as to their exact meaning, and being controversial are often confusing. Confusion should be avoided in both the regulations and the forms.

The first of these points open to several interpretations is section 181 of regulation 86. It is "that there shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year." It is clear that the government wants each partner to pick up his share of the net income of the partnership. It is also clear that the total net income to be picked up includes only reportable income and allowable deductions. But what is meant by "distributive share"?

A constant pro-rata profit-and-loss distribution introduces no difficulties in computing the percentage of net income reportable by each partner, but an agreement which varies the partners' distributive percentages as net income varies may create some difficulties. In determining the distributive share, we first find the net income and apply the partnership profit-and-loss agreement and determine what percentage of the net income each partner would receive.

There are three alternative methods of determining the net income used in computing the partner's distributive percentages: (1) the net income per books, (2) the net income as shown on item 24 of form 1065, (3) the net income on item 24 plus the partnership's income from liberty bonds.

It might be assumed that the treasury department might recognize only one net income, that found on the return; yet there is no reference to which basis to use and it is apparently left to the taxpayer to determine. The determination is often quite important. The second method, the net income per form 1065, may force one partner to assume a larger percentage of the taxable income than he has actually received. Or if the distributive share

has been found as in method one, using book profit as a basis, one partner may have to assume all the difference between book profit and taxable income. To explain this assume the following illustration:

The A & B partnership has a profit-sharing agreement as follows: "1st, A shall receive a salary of $12,000, 2nd, each shall receive 5% on his investment, 3rd, the remaining profit shall be distributed equally." A's capital account is $50,000 and B's is $100,000. For the taxable year the operating income is $200,000; operating expenses $148,000; there is a capital loss of $40,000. It can readily be seen that the net income per books is only $12,000.

Determination of net income

	1 Per books		2 Taxable income per partnership return
Gross sales	$200,000		$200,000
Less expenses	140,000		148,000
Operating profit	$ 52,000		$ 52,000
Less capital loss	40,000	(Limit)	2,000
Net income	$ 12,000		$ 50,000

Naturally, if the 1st method is used A would receive the $12,000, as salary, and B would receive nothing. A, under this method, would pick up 100 per cent. of the taxable income, or the entire $50,000.

Under the second method, applying the profit-and-loss agreement to the taxable income, the distribution would be as follows:

Partners	A	B	Total
Salary	$12,000		$12,000
Interest on investment	2,500	$5,000	7,500
Remainder equally	15,250	15,250	
Taxable share	$29,750	20,250	$50,000
Distributive %	59.5%	40.5%	100%

It might seem that for A to receive 100 per cent. of the actual book profit ($12,000) and yet be taxed for only 59.5 per cent. of the net income would be an injustice to B. This would result if method 2 were used. However, it is certainly more equitable to

distribute the unallowable capital loss between both A & B, as is done in method 2, than to make A assume it all.

Method 3, except in rare cases, would differ little from method 2, and the fact that it will not be known how much of the liberty bond interest each partner will have to pick up on his individual return until he has completed that return makes it appear to be little improvement on method 2. It would cause more bother and would not result in any particular advantage.

Any one specific method is apt to result in injustices from the viewpoint of some one of the partners who would be forced to pick up more taxable income than would be required by some other method. However, in view of the multitude of situations that might exist, method 2 seems the most equitable of any one solution.

My second criticism concerns the earned income credit. The regulations state that a partner may claim as earned income a reasonable amount for his personal services up to 20 per cent. of his share of the net income of the partnership. Assuming that "his share" has been definitely settled, what amount will be used as net income? (1) Is it the figure shown on item 5 on the individual return, entitled "income from partnership," yet excluding both dividends and liberty bond interest? (2) Is it the partners' share of item 24 on the partnership return which includes dividends but not liberty bond interest? In view of the present forms the latter would seem to be the more logical, as earned income is computed on the partnership return, before the amount of liberty bond interest which the partners will pick up is known. (3) Or does net income mean all reportable income on the individual return, including the amount of partnership profit in item 5, dividends in item 10a, and the liberty bond interest to the amount that is reportable in item 9?

In the vast majority of cases this difference would have little effect on the amount of tax payable and the selection of 20 per cent. of any item is a purely arbitrary basis that could be changed, but for the sole sake of simplification this regulation should be clarified.

The third item is that there is no clear connection between the individual return and the partnership return. The purpose of the partnership return, form 1065, is to facilitate and check the return by the partner as an individual taxpayer, yet no provision has been made on form 1065 to show the definite amount which

each partner should place in item 5 on the individual return. While it is true that by a small exercise of arithmetic this can be determined by one who knows what is wanted, for one who doesn't, it causes needless trouble.

To illustrate this weakness in the form, a comparison may be made of the present form and one that might be an improvement.

Partners or members' shares of income and credits

Column	Present form	Column	Suggested form
1.	Name and address of partner	1.	Name and address of partner
2.	Percentage of net income	2.	Percentage of net income
3.	Dividend (item 10 (a) above)	3.	% times item 24 (above)
4.	Earned income	4.	% times dividends (item 10 (a) above)
5.	Balance of net income (item 24 minus sum of amounts in columns 3 and 4)	5.	Balance of net income (item 3 minus item 4)
6.	Income tax paid at the source (2% of item 6)	6.	% times liberty bonds and treasury bonds owned
7.	Income tax paid foreign countries or United States possessions	7.	Earned income
		8.	Income tax paid at the source (2% of item 6)
		9.	Income tax paid foreign countries

Item 5 on the present form means nothing in itself. Item 5 on the suggested form would show the actual amount the partner would pick up in item 5 on the individual return. Item 4 will go into 10a, as No. 3 now does; item 6 will go in schedule D on the individual return. Items 7, 8 and 9 correspond to items 4, 6 and 7, respectively, on the present form.

I do not claim that the suggestions, concerning (1) definite instruction relative to the determination of "partners' shares," (2) a definition of the basis for finding the "earned income credit" and (3) a revision in the partnership form, are the best suggestions that can be made to clarify partnership procedure, but I do believe that they would simplify the return considerably.