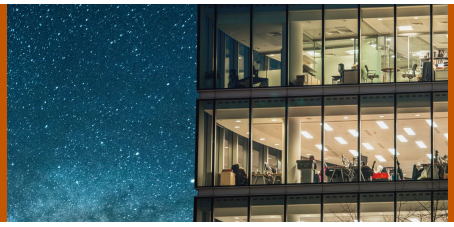
JO Knows Why Tax Basis Matters in a Partnership

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What is tax basis in a partnership? Tax basis represents a partner's investment in the underlying partnership adjusted for various items. It will be starting point for determining the gain on the sale of that partnership interest. In the simplest of terms, if you contributed $1,000 into a partnership, that would be your basis and if you turned around and sold it the following day for $2,000, you would have a gain of $1,000 (the $2,000 you sold the interest for less the $1,000 you put into the partnership). More importantly, tax basis determines a partner's ability to deduct losses and take distributions without paying taxes.

That seems easy enough but tax basis is far more complicated especially if you are typically going to hold that investment for years. What else affects tax basis and how does it affect my tax return?

Adjustments to Tax Basis

The very first thing that is going to affect tax basis is your initial contribution into the partnership and any subsequent contributions. After that, your basis is increased by items of income and gain allocated to you, it is reduced by items of deductions and losses allocated to you and reduced further for any distributions you receive from the partnership. The allocation of income and deductions to the partner is driven from the operating agreement and may not always be equal to the partner's percentage ownership in the partnership. This can be tricky for partners expecting a prorata allocation.

Debt Basis

In addition to the actual flow of cash (a partner's contributions in and distributions out) and the income or loss activity that is allocated to a partner, the partner's share of debt also increases it's tax basis. There is a second type of basis, called at-risk basis, that is made up of the net cash into the partnership and the partner's share of the debt he/she is economically on the hook for. Those specific types of debt provide at-risk basis as well as general tax basis. Debt that a partner specifically guarantees (recourse debt) or debt that is secured by real property (qualified nonrecourse debt) increases a partner's at-risk basis. The change in that debt balance allocated to a partner year over year will either increase or decrease the partner's at-risk basis. Debt often allows the partners to take losses that exceed the actual cash invested. However, over time that debt basis will disappear as the debt is paid off. When this happens, a partner will generally have net taxable income and that income will eventually bring the tax basis of the partner's capital account back to the net cash he/she put into the partnership.

How Does It Affect You?

Not only does tax basis come into play when you sell or otherwise liquidate your partnership interest in the future but it comes into play each year you are a partner. A partner's basis will determine how much a partner may withdraw without recognizing gain or how much in losses a partner may deduct without being limited. If the partner takes distributions in excess of their basis then there will be a gain reported for that difference. If a partner is allocated loss from a partnership but they do not have sufficient basis to cover that loss, the difference is suspended and carried forward to be used in another year.

You should be tracking your tax basis in every partnership you are invested in because it affects the taxability of that partnership's activity allocated to you each year. There can be differences however in a partner's true tax basis (outside basis) and what is reported on the return as the partner's tax basis (inside basis), which is beyond the scope of this article.

The importance of tax basis cannot be overstated. It is the driving force behind how a partner is taxed each and every year. Without this information a partner can be affected in a variety of unexpected ways, including creating taxable income that

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may not have been anticipated.

It's important to work with an advisor that understand the complications of partnership and partner tax basis. If you feel like you do not have a good grasp of your basis within a partnership or feel like you are in need a guidance, we are here to help.

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