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Partnership Taxes

Make sure you know the basics when you file taxes on profits from a partnership.

Partnerships are unincorporated businesses that are run by two or more owners. Because partnerships do not have corporate tax status, the IRS doesn't have the power to tax them directly. Instead, the IRS taxes the profits that flow to individual partners as personal income. When you file your personal income tax return, you'll need to be aware of the issues involved in reporting profits and losses from your partnership.

Reporting Income

Though a partnership doesn't pay taxes on its profits, it does declare its operating losses and profits to the IRS in Form 1065. The partnership must also send Form K-1 to owners that states profits/losses allocated to each partner (the K-1 is reported on line 17 of your personal tax return 1040). Through these forms, both the IRS and every partner is made aware of how much is owed to the IRS by each partner.

Even before you receive your Form K-1, you'll need to estimate the tax amount you owe. This is to be sure that you set aside a sufficient amount of money to pay your taxes.

Distributive Shares

Whether or not each partner actually receives the amount stated on Form K-1 is irrelevant. The IRS taxes based on a partner's "distributive share," which is the percentage of the profits the partner is entitled to. For example, if the partnership agreement states, or the partners simply agree, that a certain percentage of profits should stay within the partnership (e.g., to pay for expansion or overhead), this doesn't matter to the IRS. The focus is on what each partner's share ought to be. Otherwise, partnerships could retain profits to avoid paying taxes.

The distributive share of each partner is determined by the partnership agreement. In the absence of a written partnership agreement, the partnership's profits will be split evenly. For example, if the partnership agreement states that you will receive 70% of the profits and losses, and your partner will be allocated the other 30%, then that 70/30 split will represent each of your distributive shares. If there's no written agreement, each of your distributive shares will be 50% of profits and losses.

Special Allocations

A special allocation is when a partnership decides to allocate shares of profits in a way that's different from that specified in the partnership agreement, or in unequal shares for a partnership that doesn't have a written agreement. For example, if you've been splitting profits equally with your partner but then decide to split them 60/40 one year, you may do so, but your reason must be for a substantial economic reason (perhaps your partner took an extended period off to travel and therefore didn't work as much). If it's not, and the IRS determines that the change was made primarily to lessen the aggregate tax burden of the partners, then the IRS will re-allocate the special allocation and you'll have to pay taxes according to your regular schedule.

Special allocation rules are complicated, so you should consult a tax attorney or accountant before making such changes.

Other Partnership Taxes

There are several tax issues partners must consider when filing their tax returns. Partners are considered to be self-employed, not employees, and therefore need to file a Schedule SE with their Form 1040 to pay their self employment taxes.

Because of this self employed status, you're also responsible to pay your share of Social Security taxes and Medicare. Partners are responsible for paying double of what a normal employee would pay (because employers normally match

employees' contributions and by being self employed, you're both employer and employee), but their tax burden is reduced by the allowance of deducting half of the self employment contribution from taxable income.

Decreasing Your Tax Burden Through Deductions

While paying the above taxes can be a complicated process that threatens your partnership's sense of financial well-being, keep in mind that you can make business deductions for any business-related expense. In other words, your taxable income decreases with every dollar you spend traveling, purchasing supplies, taking a client out for a meal, and anything else related to your business making money. It's often a large portion of your revenue and will reduce your taxable income (and therefore, your taxes) by a significant amount.

Forming a Corporation

While a partnership has its advantages, under certain circumstances, forming a corporate entity has tax advantages. The biggest difference regarding taxes between a partnership and corporation is that partners pay for taxes of the partnership on their individual tax returns, whereas corporations are taxed directly by the IRS and pay through the corporation.

In a partnership, even if partners agree to leave money in the partnership (for overhead, expansion costs, etc.), rather than taking every dime of their profits, the partners still pay personal income tax on the money left in the partnership. But if you leave between around $30,000 and $50,000 in the partnership, purely from a tax perspective, you're better off forming a corporation. The corporate tax rate is 15% for income up to $50,000 and 25% between $50,000 and $75,000. The personal income tax rate is 25% between $34,000 and $82,000.

For example, if you want to keep $35,000 of your profits in the partnership, that money will still be taxed as your personal income, most likely at a rate of 25-28%. If your business were incorporated, however, the $35,000 would be taxed at a corporate tax rate of 15%.

Of course, forming a corporation has headaches of its own, and it's not for everyone, but if you fall into the category just described, it's certainly worth consideration.

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