**8764. How is a partnership taxed?**

With the exception of certain publicly traded partnerships, a partnership is not taxed at the entity level.[[1]](#footnote-1) Despite this, the partnership must file an information return on Form 1065 that shows its taxable ordinary income or loss and capital gain or loss. Unlike in the case of a sole proprietorship (see Q 8759), the partnership is regarded as a separate entity for the purpose of computing taxable income, and business expenses of the partnership may be deducted.

In general, a partnership calculates taxable income in the same manner as individuals, except that the standard deduction, personal exemptions, and expenses of a purely personal nature are not allowed.[[2]](#footnote-2) The partnership may also be entitled to a deduction for production activities. Each partner must report his share of partnership profits, whether distributed or not, on his individual return.

In general, after the partnership calculates its taxable income, items of income, gain, loss, deduction or credit are allocated among the partners pursuant to the partnership agreement’s provisions, and the partners are taxed on those distributions individually.[[3]](#footnote-3) These tax items are commonly allocated among the partners in direct proportion to their respective percentage ownership interests in the partnership (see Q 8765).

As part of the parnership’s income tax return, the partnership is required to issue a Form K-1 to each of the partners. This Form advises each partner how income, loss and other “pass through” items should be reported on the partner’s personal income tax return. Therefore, if an individual owns an interest in a partnership (or other “flow through entity”, such as an S Corporation or LLC), the individual cannot file their personal income tax return until after the partnership return has been completed.

The situation becomes more complicated, however, when the partnership provides for allocation of income and other cash distributions or losses in a manner which differs from the partners’ relative percentage interests in capital. Limited partnerships have long been used as a vehicle for so-called tax-sheltered investments. These ventures are typically structured to produce losses and/or tax credits, through liberal use of deductions for depreciation, natural resources depletion or exploration, and other provisions. The partnership agreements spell out the method for allocation of these tax benefits among the various classes of partners.

Thus, depending upon the objectives of the various partners, the tax allocation provisions of the partnership agreement might be drafted in order to allocate tax losses and/or credits to a particular partner or class of partners. Typically, the general partner(s), who are the organizers and managers of a venture will be treated differently from the limited partners, who are the principal providers of capital to the project. Prior to extensive reforms enacted in 1986 (see Q 8595), these types of tax shelter partnerships were widely promoted, with the partnerships’ typically substantial tax losses being allocated primarily, if not exclusively, to the passive investors.

Under current law, the allocation specified under the agreement must have a “substantial economic effect.” Essentially, this means that the IRS will scrutinize and revise the allocation of tax items among the partners to the extent necessary to be in accordance with each partner’s true economic interest in the partnership.[[4]](#footnote-4) See Q 8765 for a detailed discussion of the allocation of income and loss among partners.

Special allocation rules apply where the partner’s interest changes during the year.[[5]](#footnote-5)

A partnership which is traded on an established securities market, known as a publicly traded partnership, is taxed differently than a partnership in some instances (see Q 8772 and Q 8773).[[6]](#footnote-6) See Q 8771 for special considerations that may apply in the context of a family partnership.

1. . IRC Sec. 701. [↑](#footnote-ref-1)
2. . IRC Secs. 703(a), 63(c)(6)(D). [↑](#footnote-ref-2)
3. . IRC Sec. 704(a). [↑](#footnote-ref-3)
4. . Treas. Reg. §1.704-1(b). [↑](#footnote-ref-4)
5. . IRC Secs. 706(d), 704(b). [↑](#footnote-ref-5)
6. . IRC Sec. 7704. [↑](#footnote-ref-6)