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SUGGESTIONS FOR PRESERVING WEALTH

This newsletter was prepared by Glenn Booker. Glenn's practice centers around estate planning for property transfers and estate/trust administration. He also specializes in appraising closely-held business interests. Glenn advises clients on complex accounting and finance issues, yet his conversational approach enables him to explain such issues in simple and understandable terms. You may contact Glenn at (229)883-2441 or e-mail him at glenn.booker @gwsh-law.com.

SELECTED BASIS VERSUS CAPITAL ISSUES

A client recently called in connection with transactions involving an LLC that is taxed as a partnership. The "flow-through" nature of an LLC allows it to be taxed as if all items of income and expense flow through to the members of the LLC in proportion to their ownership interests.

The client was inquiring as to the ability of a fellow member to deduct LLC losses on that particular member's tax return. The discussion revolved around the member's basis in the LLC. It seemed that there was confusion between basis and that particular member's capital account.

A partner's basis in a partnership, or an LLC taxed as a partnership, usually equals (1) the adjusted basis of any property contributed to the partnership, plus (2) the fair market value of any services the partner performed for the partnership (i.e., the amount of ordinary income reported by the partner for services rendered the partnership).

Please note that a partnership interest also can be acquired after the partnership has been formed. If the partnership interest is purchased from another partner, the purchasing partner's basis is the amount paid for the partnership interest. The basis of a partnership interest acquired by gift is generally the donor's basis for the interest being transferred. The basis of a partnership interest acquired through inheritance generally is the fair market value of the interest on the date the partner dies.

After the partner is admitted to the partnership, the partner's basis is adjusted for numerous items. The following operating results increase the partner's adjusted basis in his or her partnership interest: (1) the partner's proportionate share of the partnership income and (2) the partner's proportionate share of any increase in partnership liabilities. Increasing the adjusted basis for the partner's share of partnership taxable income is logical since the partner has already been taxed on the income. By increasing the partner's basis, the Internal Revenue Code insures that the partner is not taxed again on the income when he or she sells the interest or receives a distribution from the partnership.

The following operating results decrease the partner's adjusted basis in his or her partnership interest: (1) the partner's proportionate share of partnership deductions and losses, (2) the partner's proportionate share of any nondeductible expenses, and (3) the partner's proportionate share of any reduction in partnership liabilities. Under no circumstances can the partner's adjusted basis for the partnership interest be reduced below zero. Decreasing the adjusted basis for the partner's share of deductible losses, deductions, and noncapitalizable, nondeductible expenditures is logical for the same reasons. An item that is deductible currently should not contribute to creating a loss when the partnership interest is sold, or a distribution is received from the partnership. Similarly, a noncapitalizable, nondeductible expenditure should never be deductible nor contribute to a loss when a subsequent sale or distribution transaction occurs.

Frequently, reference is made to a partnership's inside basis and the partner's outside basis. Inside basis refers to the adjusted basis of each partnership asset, as determined from the partnership's tax accounts. Outside basis represents each partner's basis in the partnership interest. Each partner "owns" a share of the partnership's inside basis for all of its assets, and all partners should maintain a record of their respective outside bases. Please note that a partner's basis is not reflected anywhere on the Schedule K-1, which is attached to Form 1065, the federal partnership tax form. Instead, again, each partner should maintain a personal record of adjustments to basis. Schedule K-1 does reconcile a partner's capital account, but the ending capital account balance is rarely the same amount as the partner's basis. A partner's capital account is increased by all items of income, gains, and amounts contributed by the partner. A partner's capital account is decreased by the amount of expenses, losses, and distributions made to the partner. Please note that the partner's share of liabilities are generally included in a partner's basis. These liabilities are not reported, however, as part of a partner's capital account.

In the end, it was determined that the particular LLC member had insufficient basis to take losses. These losses are considered suspended until there is sufficient basis generated through a capital contribution or through additional debt incurrence that the particular member personally guarantees directly to the lender.

Please let us know if we can help you on explaining any of these topics in order for you to better understand the nature of partnership basis and capital account reconciliations.