

Using Accounting to Introduce Partnership Tax Concepts: The Case of Bull-Dog, LLC

Garo Kalfayan, California State University, Fresno
Denise M. Patterson, California State University, Fresno
Mark Keppler, California State University, Fresno

Abstract: This fictitious case presents a novel pedagogical approach to teaching introductory partnership taxation. The premise of the case is that students will gain a more comprehensive understanding of partnership tax allocations when they follow the effects of various transactions through the partnership books and then to the partnership tax return.

LEARNING OBJECTIVES

After completing the Problem the student should understand that:

- The partnership (LLC) operating agreement determines how the accountant establishes the initial asset and capital accounts on the balance sheet.
- There may be a difference between a member's *capital* account (book equity) and a member's *basis* (tax investment) in its ownership interest.
- Income for *book* purposes may be different for tax purposes.
- Unlike a corporate equity section, the partnership (LLC) equity section (and related accounting) allows for non pro-rata distributions to partners (i.e., the partnership can make distributions to some partners without making distributions to all partners.)
- For book purposes, owners generally agree on how profits (and losses) are to be allocated among themselves. For tax purposes, the owner's allocations may be disregarded.
- Contributed inventory cannot be treated as capital assets by the LLC for at least five years.
- The amount of debt incurred by an LLC increases the LLC members' basis in their ownership interest.

BULL-DOG LLC FACTS & PROBLEM

For several years, Mr. Bull has operated a profitable sole proprietorship that purchases, renovates, and resells high price collectible automobiles. Other than some investment income (such as interest, dividends, and capital gains) this business is Mr. Bull's sole source of income. In the past, Mr. Bull has properly reported this auto dealer business activity on a Schedule C, as part of his personal income tax return.

Mr. Bull's business is growing and he needs additional help. He wants to operate the business and share ownership with Mr. Dog. Although the two are not related, they have been friends since high school and really want to own a business together.

They have agreed that both will work full time in the business, they will each contribute \$600,000 of assets (capital). Mr. Bull will contribute car inventory with a fair market value of \$600,000 (his tax basis in this inventory is \$300,000); Mr. Dog will contribute cash of \$600,000. They will share profits and losses: 60% for Mr. Bull and 40% for Mr. Dog. Although both individuals will provide equal capital contributions, Mr. Dog believes the profit and loss allocation ratio is fair since Mr. Bull has the business “know how” to make the new enterprise a success. They initially agree that neither will be paid a salary and that any distributions from the business must be approved by both owners. Selected clauses of the LLC Operating agreement are provided as a handout.

On their personal tax returns, Mr. Bull and Mr. Dog have the same marginal tax rate (28%), however, Mr. Bull has a \$100,000 capital loss carryforward from prior years’ stock market losses. After consulting with an attorney, the two men form the limited liability company: “Bull-Dog LLC.”

Note 1: This problem involves an LLC where the owners are called “members” (instead of partners) and an ownership interest is referred to as a “membership interest” (instead of a partnership interest).

The LLC business form has basically replaced the general partnership business form because the LLC members, unlike general partners, are not personally liable for business debts (unless they personally guarantee the debt).

An LLC also has several legal advantages over a corporation such as - all LLC owners have an automatic right to manage, LLC profits can be allocated in a different percentage than contributed capital, and LLC distributions can be non-pro rata (distributions can be made solely to one owner).

Note 2: Many different *legal* entities are treated as a partnership for tax purposes. A general partnership, a limited partnership, a limited liability company, and a limited liability partnership are taxed as a partnership unless the owners elect otherwise. IRC 761; Treas. Reg. 301.7701-2

LLC Formation and Year 1 Transactions

Initial Formation for Bull-Dog LLC. Assume Bull-Dog LLC is formed, a business bank account is established, and title to the contributed cars is transferred from Mr. Bull to Bull-Dog LLC. You are the accountant and tax return preparer for Bull-Dog LLC.

Required:

- (1a)** Show the journal entry to reflect the initial capital contributed by Mr. Bull and Mr. Dog. Show the Bull-Dog LLC beginning balance sheet.

- (1b)** Determine the LLC’s tax basis (“inside basis”) in its assets *and* each member’s tax basis (“outside basis”) in their membership interest.

(1c) Is each member's tax basis the same as their recorded capital accounts? Explain any differences between the member's capital account and tax basis.

Transactions during Year 1. During Year 1:

- The LLC sells the contributed cars for \$700,000. Although the cars were inventory when Mr. Bull owned them, Mr. Bull and Dog tell you that the LLC held the cars as investment assets (rather than inventory). Consequently, they believe the LLC's sale of the cars should be treated as the sale of capital assets for tax purposes.
- The LLC earned and received \$20,000 of "other revenue" (\$12,000 long term capital gain income and \$8,000 of qualified dividend income) from investing some of its cash balance in mutual funds. For book purposes, they will divide the other revenue according to their normal profit sharing ratio. For tax purposes they tell you that they want Mr. Bull to be allocated the entire \$12,000 of long term capital gain income and Mr. Dog to be allocated the entire \$8,000 of qualified dividend income.
- The members agree to allow Mr. Dog to withdraw \$30,000 of capital.

Required:

(2a) Show the journal entries for the sale of cars, the receipt of the other revenue, and the withdrawal by Mr. Dog.

(2b) How much profit (book net income) did the LLC have? Show the Bull-Dog LLC income statement for Year 1.

(2c) Allocate the profit (book net income) to the respective capital accounts of Mr. Bull and Mr. Dog. Show the Bull-Dog LLC year-end balance sheet.

(2d) How much and what types of *taxable* income does the LLC have?

(2e) How much non-separately stated and separately stated taxable income should be allocated to each of the member's tax returns?

(**Note:** this is not a journal entry. It is done "off the books," usually in the working papers when preparing the tax return.)

(2f) After considering the above transactions and allocation of tax results to each of the members, what is each of the member's basis ("outside basis") in their LLC interests? Is it the same as their capital accounts?

Year 2 Transaction – LLC debt

At the beginning of Year 2, Mr. Bull and Mr. Dog amended the “Allocation of Profits and Losses” clause in the Operating Agreement and agreed to equally split profits and losses (50%/50%). Also, they each contributed additional cash to Bull-Dog LLC. Mr. Bull contributed \$28,000; Mr. Dog contributed \$82,000. This resulted in the following Year 2 Beginning Balance Sheet:

<u>Bull-Dog LLC Beginning Year 2 Balance Sheet</u>			
<u>Assets</u>		<u>Liabilities & Capital</u>	
Cash	\$1,400,000	Debt	\$0
		Mr. Bull - Capital	\$700,000
		Mr. Dog – Capital	\$700,000

(Note: Each member’s tax basis (“outside basis”) in his LLC interest is also \$700,000.

Transaction during Year 2. During Year 2:

The LLC buys \$200,000 of cars, financed through the bank. The bank loan requires the personal guarantee of both Mr. Bull and Mr. Dog. They agree to each be liable for 50% of the outstanding obligation.

Required:

- (3a) Show the journal entry to record the LLC purchase of the cars.
- (3b) Show the Bull-Dog LLC balance sheet after taking into account the journal entry to record the car purchase.
- (3c) After considering the car purchase, what is each members’ tax basis in the LLC and why is it different than their capital accounts?

BULL-DOG LLC OPERATING AGREEMENT

Selected Clauses

***I. Initial Capital Contributions** - An individual capital account shall be maintained for each member, and the member’s initial capital contribution in cash or fair market value of property (less liabilities) contributed to the partnership shall be credited to that account. Each member shall contribute and be credited the amount of money and property specified below:*

*Bull: Car inventory with a FMV of \$600,000 and a tax basis of \$300,000.
Dog: \$600,000*

(Note: Accountants use clause I. above to set up the LLC’s initial balance sheet.)

II. Allocation of Profits and Losses - *The profits and losses (and any item thereof) of the Company shall be allocated for Company book and tax purposes to a member in accordance with the member's percentage interest as provided below:*

Mr. Bull 60% Mr. Dog: 40%

(**Note:** Accountants use clause II. above to divide income or loss among the members' capital accounts. The owners' agreed allocations will be respected for tax purposes except certain situations such as: the allocation lacks substantial economic effect, involves pre-contribution gain, or violates family partnership rules.)

III. (1) Capital Account Maintenance - *Capital accounts shall be maintained in accordance with Treasury Regulation section 1.704-1(b)(2)(iv).*

III. (2) Distributions according to Positive Capital Accounts - *Upon Liquidation of the LLC or any LLC interest, distributions must be made according to positive capital accounts.*

III. (3) Qualified Income Offset - *A member is not required to make additional capital contributions to restore a negative capital account. If any member receives a distribution, allocation, or adjustment which reduces their capital account below zero, that member will be allocated items of company income and gain as quickly as possible in an amount sufficient to eliminate such deficit and restore the capital account to zero or a positive balance.*

(**Note:** The government requires the three clauses above, III.(1),(2),&(3), in order for the LLC's allocation of items to be respected for tax purposes. The first clause, III.(1), basically requires that an item allocated to a member for tax purposes, must also be allocated to the member's capital account (book purposes). This will insure that an allocation for tax purposes will also "economically effect" the member's capital (wealth). The last two clauses, III.(2) & III.(3) make sure that the member's capital account has meaning upon liquidation. If a tax allocation affected a member's capital, but the member's capital account was ignored upon liquidation, the tax allocation would not affect the amount of money a member ultimately receives (i.e. not have an economic effect on the member).

Teaching Note/Instructor Manual with solutions available from the Journal of Business Cases and Applications.
