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Some Accounting Problems in the Preparation of the Partnership Return of Income

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SOME ACCOUNTING PROBLEMS IN THE PREPARATION OF THE PARTNERSHIP RETURN OF INCOME*

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MANY of the accounting problems that arise in the preparation of the partnership return of income are the result of the basic difference between the return required of the partnership under the federal income tax law and the returns required of individuals and corporations. The partnership is not required to pay any tax, whereas individuals and corporations are required to do so. Strictly speaking, therefore, the partnership return is not a tax return at all, but rather an information return. This is borne out by the fact that the official designation of Form 1065 is "Partnership Return of Income" and not partnership tax return.

The accounting purpose in the preparation of an income statement for a partnership is to reflect fairly the net income of the entity. The purpose underlying the preparation of the income statement for use in the partnership return of income is to reflect the distributive shares of the individual partners. It will be seen that whatever differences occur between the income statement prepared by the accountant for the use of the partnership management and the income statement prepared for use in the preparation of the partnership return of income result from the fact that there is this sharp distinction between the primary aims of the two statements.

Since the partnership entity is not taxed as such, it is necessary for the federal income tax authorities to be informed with respect to every item of income received from the partnership by the individual partners, regardless of whether or not the partnership management regards those items as expenses of the business and regardless of whether or not, they are in fact, expenses of the business entity.

In order to illustrate the important points of difference between the income statement prepared for the use of the partnership management and the income statement prepared for use in the partnership return of income, a sample income statement of a partnership is given below. This income statement is not submitted as a model because it is defective in several respects, but it is a sample of an income statement that might be presented to a lawyer as a basis for the preparation of the partnership return.

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DOE & ROE

INCOME STATEMENT, YEAR ENDED DECEMBER 31, 1945

Net Sales			$136,828.70
Cost of Sales:			
Inventory, January 1, 1945		$ 24,740.82	
Raw Materials & Mfg. Supplies		33,402.20	
Factory Labor		37,807.64	
Depreciation—Factory		2,519.47	
Manufacturing Expense		6,047.20	
Taxes—Factory		2,153.59	
Total		$106,670.92	
Less Inventory, December 31, 1945		18,633.25	
Remainder—Cost of Sales			$ 88,037.67
Gross Profit			$ 48,791.03
Expenses:			
Advertising and Selling Expenses		$ 2,346.42	
Salaries and Wages—Admin., Sell. & Office		30,186.35	
Postage, Telephone & Telegraph		570.09	
Stationery and Printing		298.81	
Auditing and Legal Expenses		617.56	
Federal and State Unemployment Insurance—Office		526.45	
Social Security Taxes—Office		174.90	
Electricity		663.06	
Fuel		473.10	
Rent		2,106.00	
Repairs		432.49	
Depreciation:—			
Shelving, etc.	$675.98		
Delivery Truck	640.00		
Furniture & Fixtures	116.78	1,432.76	
Insurance		673.32	
Other		152.25	
Total Expenses			$ 40,653.56
Net Profit from Operations			$ 8,137.47
Other Income:			
Profit on Sale of Securities		$ 157.16	
Commissions Earned		109.84	
Bad Debts Recovered		38.06	
Total Other Income			$ 305.06
Gross Income			$ 8,442.53
Income Charges:			
Interest on Capital		$ 1,500.00	
Interest on Current Indebtedness		181.79	
Provision for Doubtful Accounts		1,268.71	
Total Income Charges			$ 2,950.50
Net Income (to be distributed)			$ 5,492.03

The principal defect in the above statement from the point of view of the federal income tax law is that it does not show the amounts paid to the individual partners. Because of this defect, the distributive shares of the individual partners cannot be computed from the face of the statement. The income statement, therefore, must be carefully analyzed and supporting figures obtained either from the bookkeeper or from the partners themselves. The method of procedure in analyzing the income statement and of reconciling the figures shown thereon with the figures shown in the partnership return is discussed in the following paragraphs.

Let us assume that you have been engaged to prepare not only the partnership return of income but the individual returns of the partners as well.

For your use in the preparation of the individual tax returns of the partners, each partner submits to you a statement showing various items of income comprising the following:

John Doe	
Salary	$ 7,000.00
Interest on Investments	4,500.00
Rentals	5,900.00
Profits from Partnership	3,862.32[1]
Total	$21,262.32
Richard Roe	
Salary	$ 5,000.00
Interest on Investments	3,000.00
Profits from Partnership	2,574.88[2]
Total	$10,574.88

For your use in the preparation of the partnership return of income, the partners submit to you the income statement shown on page 45.

Since the primary purpose of the partnership return of income is to reflect the distributive shares of the individual partners rather than the net income of the partnership entity, attention should first be directed to the partnership agreement because an understanding of the internal arrangements of this agreement is essential to a proper computation of the distributive shares.

If the partnership agreement is not in your files, it should be obtained from the partners and read.

Let us assume that the partnership agreement of Doe and Roe provides as follows:— "During the year 1944 John Doe shall receive a salary of $7,000.00 and Richard Roe a salary of $5,000.00; during 1945

[1] 1944, received in 1945.
[2] 1944, received in 1945.

and thereafter John Doe shall receive a salary of $7,500.00 and Richard Roe a salary of $5,200.00." The partnership agreement further continues:— "Interest at the annual rate of 6% computed monthly on balances in the capital and loan accounts is payable at the end of the year after the books have been closed. The balance of the profits or losses is to be shared in the ratio of 60% to John Doe and 40% to Richard Roe."

From a reading of the agreement it will be seen that the partners received salaries and interest from the partnership as well as their respective shares of the profits (or losses). Although no other items of income are specifically mentioned in the formal partnership agreement that does not mean that there are no other items. A comparison of the facts disclosed by this analysis should then be made with the statement of income submitted by the individual partners.

The review of the income statement begins with the first item shown. There are some differences between the method of showing net sales and cost of sales as they are presented on the income statement submitted at the beginning of this article and the presentation of sales and cost of sales for the partnership return of income, but because these differences are not peculiar to the partnership return and apply to all returns for business entities, discussion will be deferred to the end of the article.

Upon inquiry it was learned that no part of the amount shown for advertising and selling expenses was paid either to John Doe or Richard Roe; the entire amount being paid to others than partners, but this is not true of the second item on the income statement, namely, salaries and wages.

From the point of view of the firm of Doe and Roe, the salaries paid to the partners represent a proper expense of the business. Both Mr. Doe and Mr. Roe argue that the time that they devote to the business should be compensated at rates corresponding to that received by men performing similar work in the same line of business; that if a deduction is not made for the salaries paid to the partners then the income statement does not fairly present the net income of the business entity.

In accordance with this concept of net income, the bookkeeper prepared the income statement and included the partners' salaries in the amount shown for salaries and wages. A breakdown of this amount discloses:—

John Doe	$ 7,500.00
Richard Roe	5,200.00
Sales Manager	5,000.00
Other Employees	12,486.35
Total	$30,186.35

A review of this detail discloses another discrepancy. This schedule shows that John Doe received $7,500.00 and Richard Roe $5,200.00 whereas the data submitted by Mr. Doe and Mr. Roe for their individual returns show $7,000.00 and $5,000.00 respectively.

Upon inquiry it is found that the amounts submitted by the individual partners represent the amount of their salaries for 1944 and not for 1945; this, it will be noted, is in conformity with the partnership agreement.

When the matter is discussed with Mr. Doe and Mr. Roe they argue that, since they are on a cash basis and did not receive their 1944 salary until 1945, the amounts submitted by them are correct and should be considered as taxable income in 1945; that the amounts of $7,500.00 and $5,200.00 were not received until 1946 and that these are the amounts that should be reported in the 1946 returns.

Of course, this is not in conformity with the income tax law and it will be necessary to explain to the partners that each partner must include in his income for any year his distributive share of the income of the partnership whether or not actual distribution has been made.[3] This is true regardless of the fact that the partners are on a cash basis and the partnership itself on an accrual basis. The data sheets submitted by Mr. Doe and by Mr. Roe for their individual returns must, therefore, be corrected. The amounts of the 1945 salaries should be added to the amounts that they show as profits received from the partnership, while the amounts shown as salaries must be stricken from the list.

The item of salaries and wages on the income statement must be reduced by $12,700.00 so that it will now read $17,486.35.

Proper accounting procedure, while it would permit the showing of partners' salaries as a business expense, would, nevertheless, require that the amounts be shown separately, the amount paid to the partners as one item and the amount paid to employees as another, so that the reader can reconstruct the statement if he desires in order to show just how much each partner received.

The amounts shown for postage, telephone and telegraph, stationery and printing, auditing and legal expenses, were all paid to others than partners and no adjustment or correction is, therefore, necessary with respect to any of these figures.

Inquiry should be made, however, with respect to the next two items shown on the income statement, that is, federal and state unemployment insurance and social security taxes. Information received in response to this inquiry discloses that the firm did not deduct from the partners'

[3] INT. REV. CODE §§182, 183 (1939).

salaries any amounts falling within these categories; nor did it pay to the federal and state governments any amounts for social security taxes nor for federal or state unemployment insurance on the salaries paid to partners.

The law does not require such payments and, since none were made, no adjustment is required with respect to the income statement. If any such payments had been made, it would be necessary to exclude them from the income statement as they are not proper business expenses. Claims for refunds for the amounts so paid should be filed with the proper authorities.

The next two items on the income statement are for electricity and fuel. These items were paid to others than partners and, therefore, require no further consideration. They are proper business expenses and properly deductible on the partner return; but the next item, namely, rent, is one about which inquiry should be made.

The inclusion of the item of rentals $5,900.00 in the data submitted by Mr. Doe should be sufficient to cause the inquiry, but even if "Rentals" had not appeared in Mr. Doe's personal data sheet the inquiry should nevertheless be made.

Only rent that is paid to outsiders, that is, to others than partners can be included in the income statement on the partnership return and then only if it represents payment for the use of business property. The property must be owned by others and the partners must have no equity in it, and it must be used for business purposes. Any rent that has been paid for property used by the partners for residential purposes must not be considered as rent for the purposes of the return—nor for that matter is it a proper deduction for the partners themselves on their individual returns.

It is learned upon inquiry that the item of rent $2,106.00 shown on the income statement of the firm was paid to John Doe for property owned by him and occupied by the partnership for business purposes. This was in accordance with a special agreement between John Doe and Richard Roe.

It becomes necessary, therefore, to obtain a breakdown of the item of rental income on the personal data sheet submitted by Mr. Doe. This is found to be:—

Rental received from Doe and Roe	$2,106.00
Rentals received from other properties ..	3,794.00
Total	$5,900.00

The personal data sheet of Mr. Doe is now corrected by reducing the item of rental income from $5,900.00 to $3,794.00, and the item of rental received from Doe and Roe added to the amount shown as profits from the partnership. The partnership income statement must be adjusted by taking out the item of rent, thus reducing the expenses and increasing the final figure of net income.

The items of repairs, depreciation and insurance are found to be proper business expenses. No part of the amount shown for repairs was paid to either of the partners, and the items shown for depreciation applied only to property used for business purposes by the partnership.

Specific inquiry should be made with regard to the item of insurance, because it might be that this amount would represent premiums paid on life insurance of the partners. This would not be a proper business expense and, of course, would have to be excluded from the income statement, but in the case we are reviewing it was found to represent fire insurance, etc., in connection with the business.

The item of other expenses, \$152.25, shown on the income statement is found to include a contribution of \$100.00 to the American Red Cross. The other items represent miscellaneous expenses incurred in the ordinary course of business. Contributions are not a proper deduction on the partnership return[4] and it will be necessary, therefore, to adjust this statement, reducing other expenses to \$52.25 and thereby increasing the net income by a like amount. It is perfectly proper, however, for the individual partners to deduct their *pro rata* share of this contribution on their individual returns. It will be necessary, therefore, for us to adjust the personal data sheets for Mr. Doe and Mr. Roe by noting their respective shares in this contribution, namely, Mr. Doe \$60.00 and Mr. Roe \$40.00.

The reason for handling contributions in this way is the statutory limit on contributions by any individual and contributions made by a partnership are deemed to have been made by the individual partners.

The Internal Revenue Code provides in Section 183(6) that capital gains and losses do not constitute part of the partnership profit or loss and must, therefore, be segregated. Profits on the sale of securities are capital gains. This item of \$157.16 must be removed from the partnership income statement, thereby reducing the net income by the same amount. Three-fifths of this amount, or \$94.30, should be added to Mr. Doe's personal data sheet, and two-fifths, or \$62.86, added to the personal data sheet submitted by Mr. Roe.

The other items of income, namely, commissions earned and bad debts recovered, represent income from outside sources and no changes in the statement are necessary.

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[4] INT. REV. CODE §183(c) (1939).

The first item under the income charges on the income statement, namely, interest on capital account $1,500.00, represents the interest paid on the partners' investments in the partnership. Of this $900.00 was paid to Mr. Doe and $600.00 to Mr. Roe.

Inquiry into the nature of the second item, interest on current indebtedness $181.79, discloses that this amount includes $50.00 paid to Mr. Doe as interest at 6% on $5,000.00 loaned to the partnership for a period of sixty days and repaid by the partnership to Mr. Doe at its maturity.

These items, aggregating $1,550.00, are not proper deductions for the purpose of the partnership return and, therefore, should be added back to the net profits shown on the partnership income statement. On Mr. Doe's personal data sheet $950.00 should be added to the amount shown for partnership profits, and on Mr. Roe's personal data sheet $600.00 should be added.

Reference to the personal data sheet for Mr. Doe discloses that he listed $4,500.00 as interest on investments. This is found to include the $950.00 received from the partnership. In like manner, the $3,000.00 reported by Mr. Roe is found to include the $600.00 received from the partnership. It so happens that the amount of interest received by Mr. Doe in 1945 consisted of $900.00 applicable to 1944, received in 1945, and $50.00 applicable to 1945, received in 1945. In the case of Mr. Roe the amount received in 1945 was the same as that received in 1944. Because of the fact that the amounts reported by Mr. Doe and by Mr. Roe are correct, in spite of their misunderstanding as to the allocation between years, no change in the figures is necessary.

Consideration of the correctness of the individual 1944 returns of the partners does not enter into our discussion, but in view of what was said above with regard to salaries, and what is said here with regard to interest, an opportunity is provided to revise the 1944 returns if upon inspection they are found to have been incorrectly prepared.

In the revision of the income statement, a few other accounting problems than those discussed heretofore in this article occur but since they are not peculiar to the partnership form of business they are not discussed at length; but a careful review of the adjusted income statement, as it appears below, with the one submitted at the beginning of this article, will disclose just what these differences are.

Briefly, they are summarized as follows:—

The cost of sales section of the income statement submitted by the partnership includes items of depreciation, taxes and repairs (included in manufacturing expenses), which are required to be shown on the return as deductions; they have been removed in the following summary from cost of sales and included among the deductions.

It is desirable that complete reconcilements be prepared setting forth all differences between the income statement as submitted by the partnership and the income statement shown in the return. The income statement as revised, together with the reconcilements, follow:—

INCOME STATEMENT FOR USE IN PREPARATION OF THE PARTNERSHIP RETURN OF INCOME

Net Sales (Item 1)[5]			$136,828.70
Cost of Sales:			
Inventory, January 1, 1945		$ 24,740.82	
Raw Materials and Supplies		33,402.20	
Factory Labor		37,807.64	
Manufacturing Expenses		5,038.81	
Total		$100,989.47	
Less: Inventory, December 31, 1945		18,633.25	
Cost of Sales (Item 2)			$ 82,356.22
Gross Profit (Item 3)			$ 54,472.48
Other Income:			
Commissions Earned		$ 109.84	
Bad Debts Recovered		38.06	
Total (Item 12)			$ 147.90
Total Income (Item 13)			$ 54,620.38
Expenses:			
Salaries and Wages (Item 14)		$ 17,486.35	
Repairs (Item 16):—			
Factory	$1,008.39		
Other	432.49	1,440.88	
Interest (Item 17)		131.79	
Taxes (Item 18):—			
Factory	$2,153.59		
Other	701.35	2,854.94	
Bad Debts (Item 20)		1,268.71	
Depreciation (Item 21):—			
Factory	$2,519.47		
Other	1,432.76	3,952.23	
Other Deductions (Item 24):—			
Advertising, Selling	$2,346.42		
Postage, Telephone, Telegraph	570.09		
Stationery and Printing	298.81		
Auditing and Legal	617.56		
Electricity	663.06		
Fuel	473.10		
Insurance	673.32		
Other	52.25	5,694.61	

[5] The item numbers refer to page 1 of the Partnership Return (Form 1065).

Total (Item 25)	$ 32,829.51
Ordinary Net Income (Item 26)	$ 21,790.87
Net Long Term Capital Gain	$ 157.16

RECONCILEMENT OF FIGURES SHOWN ON PARTNERSHIP STATEMENT, AS ORIGINALLY SUBMITTED, AND THE INCOME STATEMENT FOR THE PARTNERSHIP RETURN

Cost of Sales as shown on Partnership Statement as originally submitted		$88,037.67
Less: Items Shown as Deductions on Return:—		
Depreciation—Factory	$ 2,519.47	
Taxes—Factory	2,153.59	
Repairs—Factory	1,008.39	$ 5,681.45
Cost of Sales for Partnership Return of Income		$82,356.22
Expenses as shown on Partnership Statement as originally submitted		$40,653.56
Add:—Depreciation—Factory		2,519.47
Taxes—Factory		2,153.59
Repairs—Factory		1,008.39
Interest on Current Debt		131.79
Provision for Doubtful Accounts (Bad Debts) ...		1,268.71
		$47,735.51
Less:—Amounts paid to or for account of partners:—		
Salaries	$12,700.00	
Rent	2,106.00	
Contributions	100.00	$14,906.00
Expenses per Partnership Return of Income		$32,829.51
Net Income as shown on Partnership Statement as originally submitted		$ 5,492.03
Add back:		
Partners' Salaries		12,700.00
Partners' Interest		1,550.00
Rent paid to John Doe		2,106.00
Contributions not deductible on partnership return		100.00
		$21,948.03
Less:—Profit on Sale of Securities		157.16
Net Income as shown on Income Statement for Partnership Return		$21,790.87

SUMMARY OF THE DISTRIBUTIVE SHARES OF THE PARTNERS

		Total	*John Doe*	*Richard Roe*
Salaries		$12,700.00	$ 7,500.00	$5,200.00
Interest on Capital		1,500.00	900.00	600.00
Interest on Loan		50.00	50.00	
Rent		2,106.00	2,106.00	
Contributions		100.00	60.00*	40.00*
Remainder of Profit and Loss.	$5,492.03			
Less: Capital Gain	157.16	5,334.87	3,200.92*	2,133.95*
Total		$21,790.87	$13,816.92	$7,973.95
Capital Gain		$ 157.16	$ 94.30*	$ 62.86*

* 60% to John Doe; 40% to Richard Roe.

REVISED PERSONAL DATA SHEETS

John Doe

	As Submitted	As Revised
Salary	$ 7,000.00	$ —0—
Interest	4,500.00	3,550.00
Rentals	5,900.00	3,794.00
Profits from Partnership	3,862.32	13,816.92
Capital Gain	—0—	94.30
	$21,262.32	$21,255.22

N.B. Personal return would pick up $60.00 contributions made by partnership in addition to other contributions made by Mr. Doe.

Richard Roe

	As Submitted	As Revised
Salary	$ 5,000.00	$ —0—
Interest	3,000.00	2,400.00
Profits from Partnership	2,574.88	7,973.95
Capital Gain	—0—	62.86
	$10,574.88	$10,436.81

N.B. Personal return would pick up $40.00 contributions made by partnership in addition to other contributions made by Mr. Roe.

John Doe

As Submitted	$21,262.32
Less: Partnership Profits 1944	3,862.32
	$17,400.00
Add: Partnership Profits 1945 per Income Statement	3,295.22
Salary Adjustment	500.00
Contributions	60.00
As Used for Personal Return	$21,255.22

Richard Roe

As Submitted	$10,574.88
Less: Partnership Profits 1944	2,574.88
	$ 8,000.00
Add: Partnership Profits 1945 per Income Statement	2,196.81
Salary Adjustment	200.00
Contributions	40.00
As Used for Personal Return	$10,436.81