J. of Acc. Ed. 30 (2012) 100–130

Contents lists available at SciVerse ScienceDirect

J. of Acc. Ed.

journal homepage: www.elsevier.com/locate/jaccedu

Educational Case

Using journal entries to teach partnership tax: An illustrative case

Dann G. Fisher *, Amy M. Hageman [1]

Kansas State University, Department of Accounting, College of Business Administration, 109 Calvin Hall, Manhattan, KS 66506, United States

ARTICLE INFO

Article history:
Available online 13 August 2012

Keywords:
Partnership tax
Book accounting requirements
Journal entries
Tax education

ABSTRACT

The use of journal entries to teach partnership taxation concepts provides students with a visual tool that liberates them from the memorization of formulas that has long been a staple in partnership tax education. Employing journal entries as our pedagogy, we present a case designed to be a comprehensive project for a stand-alone graduate partnership taxation course. We also provide guidance for how individual components within the case can be assigned, which could be particularly useful to instructors of business entity tax courses. Our case provides a resource that will assist instructors in teaching and students in understanding (1) the book accounting requirements, and (2) the interrelationship between the tax and book reporting requirements. Graduate tax students who completed this case in its entirety agree that the case meets its stated learning objectives, and that journal entries are an effective tool for analyzing partnership tax transactions and make learning partnership taxation easier.

1. Introduction

Subchapter K of the Internal Revenue Code – the taxation of partners and partnerships – has been a part of the Internal Revenue Code since 1954. Initially a somewhat insignificant area of the code, partnership tax law has grown significantly in stature and importance because of the remarkable growth in the use of this business form, first spawned by the real estate tax shelter activity of the late 1970s and early 1980s and then by the advent of Limited Liability Companies (LLCs are treated as

* Corresponding author. Tel.: +1 785 532 6037; fax: +1 785 532 5959.
E-mail addresses: dfisher@k-state.edu (D.G. Fisher), hagemana@k-state.edu (A.M. Hageman).
[1] Tel.: +1 785 532 4484; fax: +1 785 532 5959.

0748-5751/$ - see front matter
http://dx.doi.org/10.1016/j.jaccedu.2012.06.010

partnerships for income tax purposes) during the 1990s. The number of partnerships has been growing approximately 5% annually for the past two decades, more than doubling the number of partnerships in existence. Currently, more than 3 million partnerships are in operation (Wheeler & Shumofsky, 2010). Partnerships cover a wide range of entities, ranging from small two-person ventures to multi-million dollar hedge funds, evidencing the importance of gaining a proficiency in the rules of Subchapter K.

Despite the growing popularity of this business form, partnership taxation remains a difficult area to both teach and learn. While stand-alone partnership texts are available (such as Ricketts & Tunnell, 2011), many of the partnership tax concepts have no equivalents elsewhere in the tax code, making the instruction of this area a significant challenge for both faculty and students.

But what makes this area of the tax law difficult to grasp is also what makes it very attractive as a business form. The partnership form is enticing not only because of its conduit nature, which allows the income and deductions to pass through to the owners to be taxed, but also because of its unique ability to make special allocations of the income and deduction items to the partners. Special allocations of income and deductions may not withstand IRS scrutiny, however, unless the partnership can demonstrate that the allocations have substantial economic effect according to the rules of IRC §704(b). Briefly, these rules require the partnership to maintain book (economic) records and distribute assets upon liquidation based upon these economic numbers. Once the economic bookkeeping has been properly performed, the allocation of tax results among the partners must be made in a manner consistent with the allocation of corresponding economic results. Simply put, for each partnership transaction, the accountant is obligated to capture both the economic (book) effect and the tax effect.

We believe that a very useful way for students to understand what must be captured and reported for both book and tax purposes is through the use of journal entries. Journal entries are a particularly useful tool for students with an accounting background who are used to analyzing events and communicating via journal entries, and allow the students to visually see the book requirements and the differences between the tax and book rules, liberating them from the memorization of formulas that has long been a staple in the teaching of partnership tax. Through the use of journal entries, students gain a much needed understanding of how to reconcile the differences, as required by Form 1065, and they learn a process for generating the book numbers that, in all likelihood, have not been tracked by the partnership during the year.

The use of journal entries for teaching complex tax ideas is not a new concept. Fry and Fry (1988) recommend, in a general sense, that journal entries be used in tax classes as a means of providing both a framework and a visual aid for student learning. They also assert that journal entries reduce the number of errors and oversights made by students. More specifically, Bayer, Hopkins, and Pierce (1989) argue for the use of journal entries as a tool for teaching partnership tax. They offer the use of entries as a means of reconciling tax basis accounting with financial accounting. Similarly, Balla (2001) proposes the addition of journal entries to the financial ledger of partnerships and LLCs as a means of tracking important tax attributes.

Whereas previous authors have attempted to integrate tax basis accounting with *financial* accounting, we are concerned with reconciling tax basis accounting with the *book* accounting requirements of §704. The book accounting requirements are strikingly different from financial accounting rules. Rather than relying upon historical cost, the book numbers that must be reported by the partnership are based upon fair market value. The book numbers report the economic reality of the events measuring the proceeds the partners would receive upon liquidation of the partnership. For this reason, the numbers are adjusted up and down to current fair market value at regular occurrences (e.g., contributions by partners and distributions to partners). Although reconciling tax numbers with financial accounting numbers has merit, we do not believe that students can gain ascendency over partnership tax law without a clear understanding of this book accounting process.

The purpose of this paper is to provide a case that will assist instructors in teaching and students in understanding the interrelationship between the tax and book reporting requirements. This case, in its entirety, is designed as a comprehensive project for a stand-alone graduate partnership taxation course. Instructors teaching a business entities taxation course may also find value in the case by assigning some of the individual components. We provide guidance in this teaching note on how this might be achieved, along with suggestions for how best to introduce the journal entry approach. We contribute to the tax education literature by using journal entries to teach complex partnership tax