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**Partnership
Accounting for
Contributed
Property**

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Partnership Accounting for Contributed Property

Family offices and holding companies find that using a pass-through entity such as a partnership or LLC to hold investments has many advantages. It is common for a family to hold a large asset such as a parcel of real estate for which they have a very low tax basis. Often it is advantageous to form a pass-through entity and contribute the property to this entity.

This case study outlines a fictitious situation where a family transfers real property to a pass-through entity and starts developing the property. It then describes how the family uses Financial Navigator[®] for estate planning and accounting for the business activity related to the property.

Objectives of the Family

Our fictitious family has all of the following objectives:

- Begin the yearly transfer of ownership of this illiquid asset to children or grandchildren. A senior generation often does this as part of their estate planning.
- Create an entity that can hold property and operate as a business. This entity can also protect family members from personal liability in the event of lawsuits involving the property.
- Allow a non-family member who has been a trusted employee of the family for many years to participate in the financial success of the venture.
- Create an ownership situation whereby they can discount the value of assets so that they can transfer a larger portion of the property than they could through straight gifting. This is not covered in this case study.

The Situation for this Case Study

This case study uses a fictitious family and their situation to illustrate how to account for a partnership used to meet the objectives described above.

The Family

This example involves the Smith family that operates a second and third generation family office. The original Smith family started a garage door manufacturing business outside of a major metropolitan area after World War II. The family members and their generations are as follows:

- **Ted and Louise Smith** were the first generation. He died in 1979. She died in 1983.
- **John Smith** is the son of Ted and Louise. He has managed the family business since 1972. He married **Jane** and together raised two children. John and Jane represent the second generation and currently hold title to the assets.
- **Mike Smith** is the eldest son and has worked in the family business for many years. He is now divorced.
- **Steve Smith** is the second son. He married **Kim** and has three children. Both Kim and Steve are very active in the family business.

The Land

The parents own a 120-acre tract of land near a major city that they want to subdivide and then build approximately 200 single-family homes. Since the father inherited the land from his father, the parent's tax basis is only \$1.2 million. They had the land appraised by an outside firm to be currently worth \$8 million.

Trusted Family Manager

Mr. David Lloyd has worked for the family for many years and will be overseeing this real estate project. The family wants him to have an equity ownership in the partnership and to participate in the profits as the partnership sells the land. He has agreed to contribute some of his own money in order to participate in this opportunity. These funds will also provide cash for the initial expenses that the partnership will incur.

The Development Plan

The plan the family has developed is to complete the following over the next five years:

- Create the Smith Land Development, LLC entity on Dec 1, 2004 where the parents contribute the land as their contribution of partnership capital.
- The trusted Family Manager contributes \$200,000 of cash on Dec 1, 2004. These funds come from money the family loans to him. The transaction to provide these funds is outside the scope of the partnership and so is not addressed in this case study.
- Gift the maximum value of shares in the LLC allowed under tax law as an annual tax-free gift to their two children and their daughter-in-law on Dec 15, 2004 and again on Jan 15, 2005 and each year thereafter. The gift to each child and the daughter-in-law must be

limited to \$11,000 at market value or \$22,000 for both parents combined.

- Sell 30 acres on one end of the land to a local developer for \$3 million.
- Retain \$2 million of the proceeds from this first sale by the partnership and plan to use those funds to develop the remaining 90 acres. It expects to incur land development costs for surveys, road construction, and legal fees. The partnership plans to hold the \$2 million as marketable securities that will earn some income until needed for development.
- Allocate to the partners at the end of the year the investment income generated by the marketable securities portfolio.
- Distribute the remaining \$1 million to the partners on March 31, 2005 to pay the income taxes they will incur on the sale of this first parcel.

Legal Background

We should clarify several legal issues up front.

Partnership Agreement

The key document for the administration of the partnership is the Operating Agreement. The attorneys for the family create this agreement after helping the family decide the exact terms under which they will operate the partnership. It is not necessary in this case study to deal with the many other legal issues covered in the partnership agreement.

Accounting Procedures

For the sake of understanding the accounting procedures used, this case study refers to those aspects of the agreement that deal with maintaining capital accounts, allocating income, and distributing cash. Anyone responsible for accounting for a partnership must become very familiar with these provisions of the agreement in order to insure their work is in line with the intentions of the founding partners.

Gifts for Estate Planning

An experienced estate planning professional reading this case may observe that we have not taken advantage of one of the major benefits provided by a partnership. That is the ability to discount the market value of assets by claiming that the value of ownership of equity in the partnership is worth less than the same proportionate share of the asset. This is a significant benefit received from using a partnership.

The authors of this case chose not to illustrate this benefit because it would seriously distract the reader from the case's main purpose of describing partnership accounting.

Terminology

A good understanding of the key terms and their relationship to other terms is critical in a topic like this. The key terms include:

Pass-Through Entity - There are several different legal structures used to accomplish the objectives of our family. The most common is to use some form of a *pass-through entity* that pays no tax at the entity level but simply passes the tax liability through to the investors. Examples of these entities include:

- Limited Liability Company (LLC)
- Family Limited Partnership
- Other forms of Limited Liability Partnerships (LLP)
- Sub-chapter S Corporation
- Various forms of trust agreements

It is outside the scope of this document to discuss which legal form is appropriate in which cases. The example below assumes the family chooses one of these forms of pass-through entities.

Partnership – In this paper, we use the term *partnership* to describe the entity used by the family described below even though it might be a Limited Liability Company (LLC). We use this term because the type of accounting we will be using is generally described as *partnership accounting*.

Partners – We refer to the owners of this entity as *partners*. Technically, if the entity is a Limited Liability Company, the owners should be referred to as *members*. The term partners fits better with the purpose of explaining partnership accounting.

Units – The proper description for how ownership is divided among partners is by number of units. Units of an LLC or partnership serve the same functions as shares of a corporation. This document uses the terms units, but the reader can interpret this as the equivalent of shares in the partnership.

Partnership Taxation Issues

The partnership is treated as a separate entity for accounting purposes, but is not subject to income taxes itself. According to tax law, items of income, gain and loss, and deductions from partnership operations are initially determined at the partnership entity level and then passed through to the partners.

Tax Code

Because there is the potential for taxpayers to abuse partnerships as a means of avoiding taxation, Congress wrote Subchapter K of the Internal

Revenue Code to define income tax policies for partnerships. Subchapter K breaks down into four parts:

- Partnership operations (Sections 701-709)
- Contributions to partnerships (Sections 721-724)
- Distributions from partnerships (Sections 731-737)
- Transfers of partnership interests (Sections 741-743)

The three sections most important for accounting for partnerships used by families and holding companies are:

- **Section 704 (a)** – This section provides that a partner’s share of the partnership income, gain, loss or deduction is generally determined by the partnership agreement.
- **Section 704 (b)** – This section was designed to deal with potential abuses of Section 704 (a). It states that if the partnership agreement provides an allocation which lacks “substantial economic effect”, then the partners share shall be determined “in accordance with the partner’s interest in the partnership” taking into account all facts and circumstances. Because this language is vague, there are extensive IRS regulations that interpret these rules for taxpayers.
- **Section 704 (c)** – This section defines the rules for distributing capital gains when one member of the partnership contributed property which had a tax basis different from its market value at the time the partnership was formed. Because this case involves exactly this situation, we must address the provisions in Section 704 (c) in distributing income when the partnership sells any part of the land.

Accounting for Partner’s Equity – An Overview

To account properly for each partner’s equity, the user of Financial Navigator should follow each step below:

1. Create a new entity in FN called Smith Land Development LLC. This entity is the partnership itself.
2. Set up in the Chart of Accounts the necessary capital accounts to record the property or cash contributed by each partner. We know that the three partners from the third generation will receive their equity in the partnership as gifts from the second generation. Each partner receiving a gift will need to have the same accounts as the second-generation partners making the gifts.
3. Identify how many different types of income we must track to comply with the partnership agreement and the tax law.
4. Set up the necessary accounts in the Chart of Accounts to record the distribution of the capital gain income from the sale of the property. This is the most complex part of partnership accounting.

5. Set up accounts in the Chart of Accounts to record the distribution to the partners of the investment income earned by the partnership.
6. Set up accounts to record any cash distributions paid to the partners.
7. Understand the equity accounts that Financial Navigator automatically creates for the entity. Financial Navigator uses these to track the partnership's current and prior-year earnings.
8. Create accounts to hold the offsetting entries for distributing income to the partners.
9. Decide whether to record the income allocations by using simple journal entries or the more advanced, pre-programmed Automatic Entries.

The next section of this case study describes how to address each of these steps in detail.

Partners' Capital Accounts

The primary objective of partnership accounting is to maintain accounts to track the equity owned by each partner. This equity is affected by three factors:

- Contributed capital or equity received as a gift from another partner
- Net Earnings by the partnership from sale of assets and investment activities
- Distributions of cash to the partners

We must perform the accounting such that it tracks the partner's capital accounts in accordance with the tax regulations and the partnership agreement.

Tax Basis and Book Value Accounts

We first set up the accounts to track the contributed property by the second generation.

Section 704(c) of the Internal Revenue Code requires that we report to each partner their capital account based on their tax basis and book value (market value) at the time of the capital contribution. We accomplish this in Financial Navigator with each partner having the following two accounts:

- **Partner Tax Basis** – This account holds the tax basis of the partner's shares in the partnership based on:
 - The tax basis of the property contributed to the partnership as a capital contribution by the investing partner.
 - The tax basis of the shares gifted from the parent-partner to the child-partner.
- **Partner Built-in Gain** – This account holds the difference between the market value of the partner's equity and the tax basis at the time of the partner's contribution.

**Accounts for
Second and
Third
Generation**

The second-generation partners, John and Jane, each have these two accounts because they contributed the land.

We know the tax basis of the individuals receiving a gift is the same as the basis of the individuals making the gift. Therefore, each of the three members of the third generation will also have these same accounts because they are receiving their equity as a gift from the second generation.

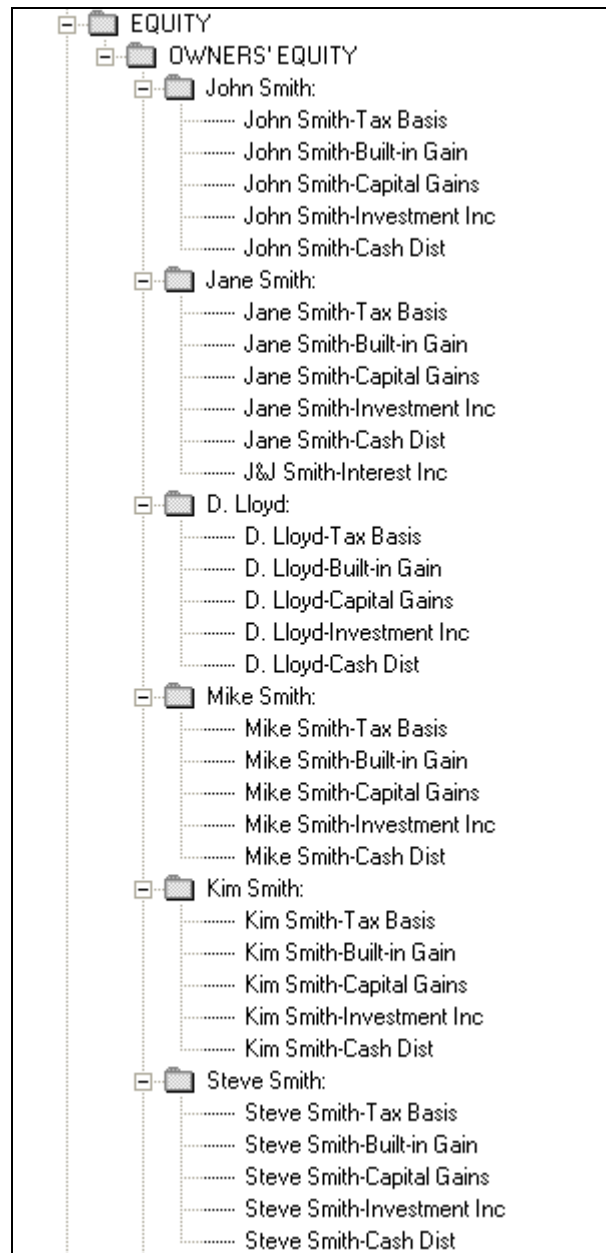
**Distributed
Income and
Cash
Accounts**

Partnership accounting requires that each partner have an account to record each type of income distributed to him or her. These accounts include:

- **Capital Gain Income** – As the partnership sells parts of the property, it recognizes capital gain income and must distribute that income to its partners. Each partner needs an account to record this income. Section 704(c) sets out specific rules for how this capital gain is to be allocated to the partners according to their tax basis in the asset that was sold.
- **Investment Income** – After it sells the first part of the land, the partnership will be holding bank deposits and marketable securities. These assets will generate investment income that it then distributes to the partners. Each partner needs to have an account to receive this income.
- **Cash Distributions** – When the partnership distributes cash to partners, the amount each partner receives reduces his or her equity in the partnership. For this partnership, we follow the common practice of accounting for these distributions by giving each partner an equity contra-account. As the partnership makes distributions, the balances of these partners' accounts have increasing negative balances offsetting their capital and distributed income accounts.

Chart of Accounts

When completed with all of the above accounts, the structure in the Chart of Accounts looks like this:



Partnership Equity Accounts

This section deals with the accounts used to track the earnings of the partnership as a whole. The previous section showed how to account for the ownership of the entity by the partner-investors. As this section shows, these two types of accounts address two separate aspects of partnership accounting.

The partnership is an entity like any other accounting entity. Therefore, it has these three standard accounts in the equity section of the balance sheet:

- **Current Year Earnings** – The balance in this account equals Net Income on the bottom line of the Income Statement.
- **Prior Year Earnings** – This account is the total of earnings for all previous years. This account appears before the current year account described above in the balance sheet.
- **Unrealized Gain and Losses** – This account appears in the earnings section of the balance sheet but does not automatically flow through the income statement.

These accounts are automatically set up by Financial Navigator when it creates the Chart of Accounts. They appear in the equity section of the balance sheet as follows:

Retained Earnings-Prior Years
Retained Earnings-Current Year
Unrealized Gains or Losses
TOTAL EQUITY
TOTAL LIABILITIES AND EQUITY

Offset for Earnings Distributions

Accounting for a partnership is different from accounting for a corporation or for individuals in one significant way. Corporations and individuals retain the earnings they generate. Those earnings, therefore, remain in the retained earnings section of the balance sheet. On the other hand, a partnership distributes all of its earnings to the appropriate accounts of its partners. A partnership needs the following additional accounts to hold the offset of the distributed income:

- **Current Year Allocated Income** – This account serves as the offset to the Net Income Current Year of the current year that is distributed back to the partners as equity. We use this same account when allocating to the partners the capital gains or investment income earned by the partnership. We know we must allocate income to the partners if the balance in this account is different than the balance of the Net Income Current Year account maintained automatically by Financial Navigator. Stated another way, if this account has the same balance as the Net Income Current Year, we know we have allocated all of the earning to the partners.
- **Current Distributed UGL** – This account serves as the offset to any Unrealized Gains & Losses incurred from the contribution of appreciated assets to the partnership.
- **Prior Year Allocated Income** – This account holds the balances of all income and losses distributed for prior years. This account allows us to close out the Current Year Allocated Income account into this

account each year. Therefore, the balance in the Current Year account starts at zero at the first of each year.

Appearance of Equity Section Because the Current Year Earnings and Prior Year Earnings are automatically included for every entity, it is not necessary to add them manually to the Chart of Accounts. Therefore, when completed, the structure in the equity section of the Balance Sheet appears as:

Allocated Income:
Current Year Allocated Inc
Current Distributed UGL
Prior Year Allocated Inc
Total Allocated Income:
TOTAL OWNERS' EQUITY
Retained Earnings-Prior Years
Retained Earnings-Current Year
Unrealized Gains or Losses
TOTAL EQUITY
TOTAL LIABILITIES AND EQUITY

The Chart of Accounts is now complete. We are ready to enter transactions to reflect the formation of the partnership and its activity.

Transactions to Form the Partnership

The first accounting transactions record the initial funding of the partnership.

Initial Land Contribution

To record the initial contribution of the land to fund the LLC entity, we make the following entry to begin the accounting for the partnership on December 1, 2004. The partnership received the land at the contributor's tax basis:

Dr. LAND	\$ 1,200,000.00	
Cr. John Smith Tax Basis		\$ 600,000.00
Cr. Jane Smith Tax Basis		600,000.00

Next, the land is updated to reflect its current market value of \$8 million:

Dr. LAND	\$ 6,800,000.00	
Cr. Unrealized Gains & Losses		\$ 6,800,000.00

Finally, we distribute the build-in gain to the capital accounts of each contributing partner:

Dr. Distributed UGL	\$ 6,800,000.00	
Cr. John Smith-Built-in Gain		\$ 3,400,000.00
Cr. Jane Smith-Built-in Gain		3,400,000.00

Initial Capital Contribution	We also make the entries to record the cash contributed by Mr. David Lloyd on December 1, 2004:	
	Dr. CASH	\$ 200,000.00
	Cr. D. Lloyd-Tax Basis	\$ 200,000.00

Transactions for Gifting

We need to calculate the amounts to use in the transactions to reflect the gifts from the parents to the third generation.

First, we determine the book value and tax basis for each gift of shares and allocate that amount to the Capital-Tax Basis account for each child.

Book Value of Gift The LLC issued 1,000,000 units of ownership in the partnership. We calculate the book value at \$8.20 per unit as follows:

$$\text{Price per Share} = \text{Total Value of Partnership} / 1,000,000 \text{ units}$$

$$\text{Price per Share} = \$8,000,000 + \$200,000 / 1,000,000 = \$8.20$$

At \$8.20 per unit, the partnership distributes 2,682.93 units to each of the children (Mike and Steve) and the spouse (Kim) for a total value of \$22,000 each (\$11,000 from each parent):

$$\text{Distributed Units} = \text{Max Value Allowed} / \text{Price per Unit}$$

$$\text{Distributed Units} = \$22,000 / \$8.20 = 2,682.93 \text{ units}$$

Tax Basis of Gift Now that we know the number of units, we need to know the tax basis of each unit.

The tax basis for the partnership's initial assets is \$1,400,000.00:

$$\text{Initial Tax Basis} = \text{Land Contribution Tax Basis} + \text{Capital Contribution Tax Basis}$$

$$\text{Initial Tax Basis} = \$1,200,000 + \$200,000 = \$1,400,000$$

We calculate the Tax Basis per Unit in the partnership to be \$1.40 as follows:

$$\text{Tax Basis per Unit} = \text{Initial Tax Basis} / 1,000,000 \text{ units}$$

$$\text{Tax Basis per Share} = \$1,400,000 / 1,000,000 = \$1.40$$

The Tax Basis for the gift of units per partner is \$3,756.10:

$$\text{Tax Basis} = \text{Tax Basis per Unit} \times \text{Distributed Units}$$

$$\text{Tax Basis} = \$1.40 \times 2,682.93 = \$3,756.10.$$

Book Value Adjustment We want to have a capital account for each partner that represents the difference between the book value and the tax basis. We call this account *Built-in Gain* and calculate it as the difference between the Tax Basis and the Market Value of the gift. The amount for each recipient is \$16,585.37 determined as follows:

$$\text{Built-in Gain} = \text{Tax Basis} - \text{Market Value}$$

$$\text{Built-in Gain} = \$22,000.00 - \$3,756.10 = \$18,243.90$$

Entries to Record Gifts

The entries we book on December 15, 2004 show the accounting for the gifts totaling \$66,000:

Dr.	John Smith-Built-in Gain	\$	27,365.85
Dr.	John Smith-Tax Basis		5,634.15
Dr.	Jane Smith-Built-in Gain		27,365.85
Dr.	Jane Smith-Tax Basis		5,634.15
Cr.	Mike-Built-in Gain	\$	18,243.90
Cr.	Mike-Tax Basis		3,756.10
Cr.	Kim- Built-in Gain		18,243.90
Cr.	Kim-Tax Basis		3,756.10
Cr.	Steve- Built-in Gain		18,243.90
Cr.	Steve-Tax Basis		3,756.10

We repeat these transactions again on Jan 15, 2005 to reflect the gifts for the year 2005. After this second round of gifts, the balances in the third generation accounts are exactly double the amounts in the above entry.

Transactions for the Sale of Contributed Assets

On March 31, 2005, the partnership sells the 30-acre parcel for \$3 million. The following are the transactions to account for the sale and distribute the capital gains to the partners.

Sale of Low-Basis Asset

We record the sale of the capital asset like any other investment sale in Financial Navigator. First, we calculate the book value and tax basis of the 30 acres we sold:

Book value:	(30 / 120 acres) x \$8 million = \$2 million
Tax Basis:	(30 / 120 acres) x \$1.2 million = \$300,000

This means we need to reduce the book value of the land on the partnership books by \$2 million and to record the capital gain of \$2,700,000.

The entry for the sale is:

Dr.	Checking	\$3,000,000.00
Cr.	LAND	\$ 2,000,000.00
Cr.	Capital Gains-Long Term	2,700,000.00
Dr.	Unrealized Gains & Losses	1,700,000.00

The partnership receives \$3 million in proceeds from the sale so it increases the checking account by this amount.

The first credit is to reduce the balance of the land account by \$2 million—the book value of the 30 acres.

Capital gains are increased by the difference between the proceeds received (\$3 million) and the tax basis (\$300,000) = \$2,700,000.

Calculating Ownership Percentage

Unrealized Gains & Losses is reduced by the difference book value (\$2 million) and the tax basis (\$300,000).

Before we can distribute the above capital gain income, we need to know the ownership percentage for each partner.

You use the equity balances of each partner to calculate their ownership percentage of the partnership based on total owners' equity. The following illustrates a simple worksheet to calculate the % of Total Owners' Equity based on capital tax basis and book value adjustment:

EQUITY	Balance	% of Equity w/ Lloyd	% of Equity w/o Lloyd
OWNERS' EQUITY			
John Smith:			
John Smith-Tax Basis	\$588,732.00		49.0610%
John Smith-Built-in Gain	\$3,345,268.00		
Total John Smith:	\$3,934,000.00	47.9756%	49.1750%
Jane Smith:			
Jane Smith-Tax Basis	\$588,732.00		49.0610%
Jane Smith-Built-in Gain	\$3,345,268.00		
Total Jane Smith:	\$3,934,000.00	47.9756%	49.1750%
D. Lloyd:			
D. Lloyd-Tax Basis	\$200,000.00	2.4390%	
Mike Smith:			
Mike Smith-Tax Basis	\$7,512.00		0.6260%
Mike Smith-Built-in Gain	\$36,488.00		
Total Mike Smith:	\$44,000.00	0.5366%	0.5500%
Kim Smith:			
Kim Smith-Tax Basis	\$7,512.00		0.6260%
Kim Smith-Built-in Gain	\$36,488.00		
Total Kim Smith:	\$44,000.00	0.5366%	0.5500%
Steve Smith:			
Steve Smith-Tax Basis	\$7,512.00		0.6260%
Steve Smith-Built-in Gain	\$36,488.00		
Total Steve Smith:	\$44,000.00	0.5366%	0.5500%

Income Allocation to Partners

We now need to make three distribution entries to the partners. They are:

- Built-in Gain
- Tax Basis
- Reduction of the unrealized gain caused by the sale

The sections below explain each of these entries in detail.

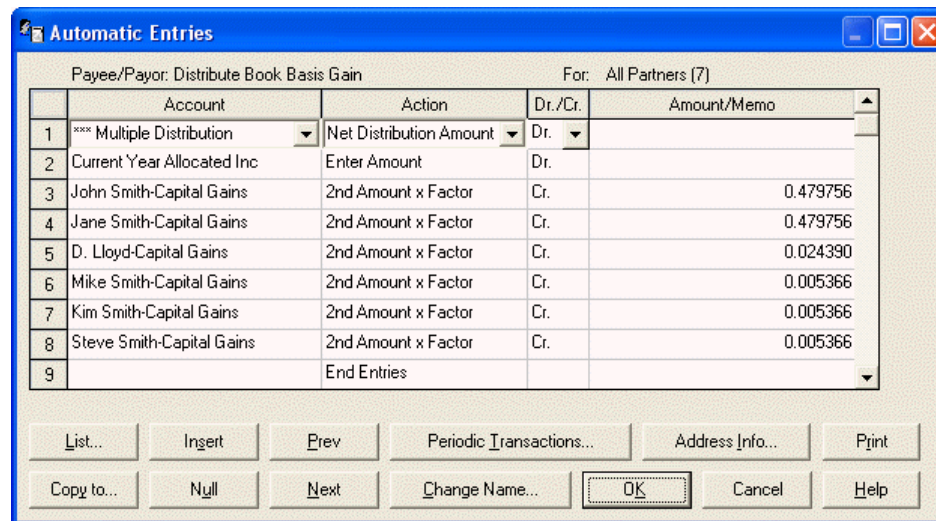
Book Basis Gain

Section 704(c) of the Internal Revenue Code says we must allocate the gain we recognize in the book value to those partners who were members of the partnership while the gain occurred. This gain is \$1 million calculated as the difference between the proceeds received and the book value of the land sold.

The following entry distributes the \$1 million book gain to the partners:

Dr.	Allocated Income	\$ 1,000,000.00	
Cr.	John Smith-Capital Gains	\$ 479,756.00	
Cr.	Jane Smith-Capital Gains	479,756.00	
Cr.	D. Lloyd-Capital Gains	24,390.00	
Cr.	Mike Smith-Capital Gains	5,366.00	
Cr.	Kim Smith-Capital Gains	5,366.00	
Cr.	Steve Smith-Capital Gains	5,366.00	

The Automatic Entry in Financial Navigator for this transaction looks like:



Tax Basis Gain Section 704(c) of the Internal Revenue Code also says we must allocate the gain we recognize over the tax basis and up to the book basis to those partners who contributed the asset with the low tax basis. This clearly includes John and Jane Smith from the second generation. It also includes the children in the third generation who received shares of the partnership as gifts. Their tax basis is the same as the basis of their parents.

For this entry, we allocate the difference between the tax basis and the book value of the 30 acres to all of the partners excluding Lloyd in proportion to their tax basis in the partnership:

Dr.	Allocated Income	\$ 1,700,000.00
Cr.	John Smith-Capital Gains	\$ 834,037.00
Cr.	Jane Smith-Capital Gains	834,037.00
Cr.	Mike Smith-Capital Gains	10,642.00
Cr.	Kim Smith-Capital Gains	10,642.00
Cr.	Steve Smith-Capital Gains	10,642.00

The partners will report the above amounts as capital gains taxable income on their personal income tax returns.

Reduction in Unrealized Gains & Losses

Lastly, the Unrealized Gain on the land was reduced by \$1,700,000 because of the sale of the 30 acres. Therefore, we must also account for this reduction in each of the owners' Built-in Gain accounts. The owners' book values are adjusted in proportion to their ownership percentage in the partnership—excluding Lloyd. The entry to rebalance each Built-in Gain account looks like this:

Dr.	John Smith-Built-in Gain	\$ 835,975.00
Dr.	Jane Smith-Built-in Gain	835,975.00
Dr.	Mike Smith- Built-in Gain	9,350.00
Dr.	Kim Smith- Built-in Gain	9,350.00
Dr.	Steve Smith- Built-in Gain	9,350.00
Cr.	Distributed UGL	\$ 1,700,000.00

Allocating Investment Income

The partnership earns investment income on the excess cash it holds. All of the partners receive a portion of the investment income earned by the partnership based on their individual ownership percentage in the partnership.

The partnership received \$60,000 worth of investment income during the year. The entry we book on December 31, 2005 to distribute this is:

Dr.	Allocated Income	\$ 60,000.00
Cr.	John Smith-Investment Inc	\$ 28,785.37
Cr.	Jane Smith-Investment Inc	28,785.37
Cr.	D. Lloyd-Investment Inc	1,463.41
Cr.	Mike Smith-Investment Inc	321.95
Cr.	Kim Smith-Investment Inc	321.95
Cr.	Steve Smith-Investment Inc	321.95

Cash Distribution

The partnership is anticipating that it will need cash to pay for the expenses of developing the land. Therefore, it intends to retain as much cash as possible. However, by selling the parcel of land and distributing this income to the partners' capital accounts, each of the partners now has a personal income tax liability for his or her share of the gain. Therefore, the partnership decides it should distribute cash to the partners to help them pay the income taxes they have incurred because of the partnership activity.

On Dec 31, 2005, the partnership distributes \$1 million to the partners in relation to the balances in their combined capital accounts. The entry for these transactions is:

Dr. John Smith-Cash Dist	\$ 479,756.10
Dr. Jane Smith-Cash Dist	479,756.10
Dr. D. Lloyd-Cash Dist	24,390.25
Dr. Mike Smith-Cash Dist	5,365.85
Dr. Kim Smith-Cash Dist	5,365.85
Dr. Steve Smith-Cash Dist	5,365.85
Cr. Checking Account	\$ 1,000,000.00

Reporting for Partnership and Partners Capital Accounts

Financial reporting for a partnership must meet two distinct needs:

- **For the Partnership as an Entity** – Show the results of the partnership as one operating entity. In many ways, these reports are similar to any small business.
- **For the Individual Partners as Investors** – Tell each partner their share of income and expenses that the partnership has passed through to them. These amounts are reflected in the balance of each partner's capital account. These reports are unique to partnership reporting in that their only purpose is to tell each partner individually the effect of the business activity on his or her capital accounts.

Reports for the Partnership

The main reports for the partnership as a whole include:

- **Partnership Balance Sheet Analysis** – A balance sheet for the partnership as of Dec 31, 2005 is included at the end of this document as Exhibit 1.
- **Partnership Income Statement** – A partnership income statement for the year ending Dec 31, 2005 is included as Exhibit 2.
- **Partnership Allocation** – In order to distribute income proportionally to the partners, we need to know each partner's Capital Contribution + Accumulated Equity to calculate the percentage of the total for all partners:

<u>EQUITY</u>	
OWNERS' EQUITY	
John Smith	\$ 3,962,785
Jane Smith	3,962,785
D. Lloyd	201,463
Mike Smith	44,322
Kim Smith	44,322
Steve Smith	44,322

By using multiple equity accounts for each partner, the tax, book, and accrued equity can be broken out individually:

<u>EQUITY</u>	
OWNERS' EQUITY	
John Smith:	
John Smith-Tax Basis	588,732
John Smith-Built-in Gain	2,509,293
John Smith-Capital Gains	1,315,731
John Smith-Investment Inc	28,785
John Smith-Cash Dist	-479,756
Total John Smith:	3,962,785
Jane Smith:	
Jane Smith-Tax Basis	588,732
Jane Smith-Built-in Gain	2,509,293
Jane Smith-Capital Gains	1,315,731
Jane Smith-Investment Inc	28,785
Jane Smith-Cash Dist	-479,756
Total Jane Smith:	3,962,785
D. Lloyd:	
D. Lloyd-Tax Basis	200,000
D. Lloyd-Capital Gains	24,390
D. Lloyd-Investment Inc	1,463
D. Lloyd-Cash Dist	-24,390
Total D. Lloyd:	201,463

- **Transaction Listings** – For documentation of the critical entries affecting all the partnership accounts, you should have printout of these entries. An example of these reports is shown at the end of this document:
 - Exhibit 3 – General Journal Transactions for 2004
 - Exhibit 4 – General Journal Transactions for 2005
 - Exhibit 5 – Checking Account Transactions for 2005
- **Automatic Entries** – Anyone performing an audit of the critical calculations will benefit from a report showing the allocation factors

used for key income allocations. Here is an excerpt from such a report:

Smith Land Development, LLC Payees With Automatic Entries Year: 2005						
No	Payee Name Account	For Action	Set#	Due Date Dr./Cr.	#	How Often Amount
7	Distribute Book Basis Gain	All Partners				irreg
	*** Multiple Distribution	Net Distribution Amount			Dr.	
	Current Year Allocated Inc (20)	Enter Amount			Dr.	
	John Smith-Capital Gains (41)	2nd Amount x F Factor			Cr.	.479756
	Jane Smith-Capital Gains (46)	2nd Amount x F Factor			Cr.	.479756
	D. Lloyd-Capital Gains (25)	2nd Amount x F Factor			Cr.	.02439
	Mike Smith-Capital Gains (26)	2nd Amount x F Factor			Cr.	.005366
	Kim Smith-Capital Gains (27)	2nd Amount x F Factor			Cr.	.005366
	Steve Smith-Capital Gains (28)	2nd Amount x F Factor			Cr.	.005366

Reports for Partners as Investors

The following Financial Navigator reports inform individual investors about the activity in their capital accounts.

- **Partner Equity Summary** – Some partners will only be interested in seeing the current balances in their capital accounts. Here is an excerpt from such a report for John Smith:

Smith Land Development, LLC Equity Analysis For Selected Accounts As of: December 31, 2005	
	<u>Balance</u>
<u>EQUITY</u>	
OWNERS' EQUITY	
John Smith:	
John Smith-Tax Basis	588,732
John Smith-Built-in Gain	2,509,293
John Smith-Capital Gains	1,315,731
John Smith-Investment Inc	28,785
John Smith-Cash Dist	-479,756
Total John Smith:	3,962,785
TOTAL OWNERS' EQUITY	3,962,785

- **Transactions for Capital Accounts** – Some partners will want to see a report that shows their beginning capital account, each entry for the period, and the ending account balance. Exhibit 6 shows this report from Financial Navigator.

Closing Out Accounts at Year-End

After we complete all the year-end reporting, we need to close out the balances in the accounts we used to record distributions during the year. We enter these following transaction before we rollover the accounts to begin entering transactions for the next year.

We record one set of entries for each partner and another type of entry for the partnership as its own entity.

Partners Capital Accounts

We know that the taxable income reported by each partner *increases* his or her tax basis. Therefore, we make the following entries to close out the distributed income accounts into the Tax Basis partnership account for John Smith:

Dr. John Smith–Cap Gains	\$ 1,315,731.00
Dr. John Smith–Investment Inc	28,785.37
Cr. John Smith–Tax Basis	\$ 1,315,731.00

We know that the cash distributed to each partner *decreases* his or her tax basis. Therefore, we make the following entries to close out the cash distributions account into the Tax Basis partnership account for John Smith:

Dr. John Smith–Tax Basis	\$ 479,756.10
Cr. John Smith–Cash Dist	\$ 479,756.10

We repeat the above entries for each of the other four partners.

Partnership Distribution Accounts

We have one last housekeeping function to complete before beginning the new year.

We want the Current Year Allocated Income account to serve as a check for when we need to distribute current year partnership income. We know Financial Navigator automatically closes out the Current Year Allocated Income account into the Prior Year Income Account when we begin a new year.

We manually make the following comparable entry to transfer the balance of the Current Year Allocated Income to the prior year account:

Dr. Prior Year Allocated Income	\$ 2,760,000.00
Cr. Current Year Allocated Income	\$ 2,760,000.00

There is no need to make a comparable entry for the Distributed UGL account. This account mirrors the partnership's Unrealized Gain or Losses account. The balances in both accounts carry over to the new year.

Reports for New Year

Attached as Exhibit 7 is the Balance Sheet – Starting Balances report for 2006 after we begin the new year and before we enter any transactions.

Alternative Accounting Methods

This document has outlined one approach to partnership accounting. As with many aspects of accounting, there are often many ways to handling accounting. All of which are perfectly acceptable. Here is an alternative to the methods used in this document.

Accounting for Unrealized Gains and Losses

In some situations, a partnership wants to have all earnings, both realized and unrealized, flow through the income statement. Financial Navigator allows you to do this by setting up your own account in the Income Section of the Chart of Accounts. You then make a journal entry to transfer the balance from the FN Unrealized Gain or Loss account to your account that appears on the balance sheet.

The advantage of this approach is that you can distribute all income with one allocation entry instead of two.

Conclusion

Because of the rapid growth of family offices and investor holding companies, there are more and more investments now held by a form of pass-through entity. These entities use partnership accounting to report income tax information and investment results to the investor-partners.

One popular use of partnerships is to hold contributed assets that have a low tax basis. This adds the requirement of complying with IRC Section 704(b) and (c) to accounting and reporting.

This case study shows how Financial Navigator handles partnership accounting and the special income tax reporting requirements.

Authorities and Reference Books

The material presented in this case comes from several reference books and the experience of many financial professionals.

Authorities

This document was written through a combined effort of the Financial Navigator Int'l team and the following users of the Financial Navigator software:

- **Lynne Kaplan, CPA**, Partner, Gross, Kaplan, and Osiol, LLC., Rosemont, IL

Reference Books

The following are just a few of the many books and references that explain in detail the concepts applied in this case study.

- Burke, Karen C. *Federal Income Taxation of Partners and Partnerships in a Nutshell*. 2nd ed. St. Paul, MN: West Group, 1999. <http://west.thomson.com/product/22071706/product.asp>

- Horngren, Charles T. and Walter T. Harrison, Jr. *Accounting*. 6th ed. Englewood Cliffs, NJ: Prentice Hall, 2005.
<http://vig.prenhall.com/catalog/academic/product/0,1144,0131088513,00.html>
- Internal Revenue Service, Department of Treasury. *Internal Revenue Code*. Washington, D.C.: U.S. Government Printing Office, 1 Apr 2004. <http://www.access.gpo.gov/cgi-bin/cfrassemble.cgi?title=200326>
- ———. *Introduction to Estate and Gift Taxes*. Publication 950. Washington, D.C.: U.S. Government Printing Office, Sept 2004. <http://www.irs.gov/pub/irs-pdf/p950.pdf>
- IRS Regulations
- Pahler, Arnold J. and Joseph E. Mori. *Advanced Accounting*. 7th ed. Ft. Worth, TX: The Dryden Press, 1997.

Notes

Disclaimer: Financial Navigator International (FNI) prepared this document to provide you with accurate and authoritative information about this subject. Its primary purpose is to illustrate the use of Financial Navigator software programs in a particular situation.

FNI is not engaged in rendering tax planning or legal services. This publication is not a substitute for the advice of a qualified tax professional or attorney. If you require income tax planning or legal advice, you should seek the services of a qualified professional.

Smith Land Development, LLC
Balance Sheet Analysis
As of: December 31, 2005

	<u>Balance</u>
<u>ASSETS</u>	
CURRENT ASSETS	
Cash on Hand:	
CASH	200,000
Total Cash on Hand:	200,000
Checking Accounts:	
Checking Account	2,060,000
Total Checking Accounts:	2,060,000
TOTAL CURRENT ASSETS	2,260,000
LONG-TERM INVESTMENTS	
Undeveloped Land:	
LAND	6,000,000
Total Undeveloped Land:	6,000,000
TOTAL LONG-TERM INVESTMENTS	6,000,000
TOTAL ASSETS	8,260,000

<u>EQUITY</u>	
OWNERS' EQUITY	
John Smith:	
John Smith-Tax Basis	588,732
John Smith-Built-in Gain	2,509,293
John Smith-Capital Gains	1,315,731
John Smith-Investment Inc	28,785
John Smith-Cash Dist	-479,756
Total John Smith:	3,962,785
Jane Smith:	
Jane Smith-Tax Basis	588,732
Jane Smith-Built-in Gain	2,509,293
Jane Smith-Capital Gains	1,315,731
Jane Smith-Investment Inc	28,785
Jane Smith-Cash Dist	-479,756
Total Jane Smith:	3,962,785
D. Lloyd:	
D. Lloyd-Tax Basis	200,000
D. Lloyd-Capital Gains	24,390
D. Lloyd-Investment Inc	1,463
D. Lloyd-Cash Dist	-24,390
Total D. Lloyd:	201,463
Mike Smith:	
Mike Smith-Tax Basis	7,512

**Smith Land Development, LLC
Balance Sheet Analysis
As of: December 31, 2005**

	<u>Balance</u>
Mike Smith-Built-in Gain	27,138
Mike Smith-Capital Gains	14,716
Mike Smith-Investment Inc	322
Mike Smith-Cash Dist	-5,366
Total Mike Smith:	44,322
Kim Smith:	
Kim Smith-Tax Basis	7,512
Kim Smith-Built-in Gain	27,138
Kim Smith-Capital Gains	14,716
Kim Smith-Investment Inc	322
Kim Smith-Cash Dist	-5,366
Total Kim Smith:	44,322
Steve Smith:	
Steve Smith-Tax Basis	7,512
Steve Smith-Built-in Gain	27,138
Steve Smith-Capital Gains	14,716
Steve Smith-Investment Inc	322
Steve Smith-Cash Dist	-5,366
Total Steve Smith:	44,322
Allocated Income:	
Current Year Allocated Inc	-2,760,000
Current Distributed UGL	-5,100,000
Total Allocated Income:	-7,860,000
TOTAL OWNERS' EQUITY	399,999
Net Income-Current Year	2,760,000
Unrealized Gains or Losses	5,100,000
TOTAL EQUITY	8,260,000
TOTAL LIABILITIES AND EQUITY	8,260,000

Smith Land Development, LLC
Income Statement
December & Year-to-Date
For the Period Ending: December 31, 2005

	<u>Dec Actual</u>	<u>Ytd Actual</u>
<u>INCOME</u>		
INVESTMENT INCOME		
Interest Income-Taxable:		
Interest Income-Taxable	60,000	60,000
Capital Gains-Long Term:		
Capital Gains-Long Term	0	2,700,000
TOTAL INVESTMENT INCOME	60,000	2,760,000
TOTAL INCOME	60,000	2,760,000
<u>EXPENSES</u>		
TOTAL EXPENSES	0	0
NET INCOME	60,000	2,760,000

**Smith Land Development, LLC
Transactions with Distributions
General Journal (12)
From: January 2004 To: December 2004**

<u>JE #</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Status</u>	<u>dr</u>	<u>cr</u>
	Jan 1 04	Beginning Balance			
1	Dec 1 04	Contribution of Land	C		
memo		J&J Smith contribuiton			
dr		LAND (18)		1,200,000.00	
cr		John Smith-Tax Basis (23)			600,000.00
cr		Jane Smith-Tax Basis (25)			600,000.00
2	Dec 1 04	Contribution of Cash	C		
memo		D. Llyod contribution			
dr		CASH (19)		200,000.00	
cr		D. Lloyd-Tax Basis (4)			200,000.00
3	Dec 1 04	Market Value Update (3)	C		
memo		Land to \$8 million			
cr		Unrealized Gains or Losses (1)			6,800,000.00
dr		LAND (18)		6,800,000.00	
4	Dec 1 04	Book Up Adjustment (2)	C		
memo		Book Up Adj J&J Smith			
cr		John Smith-Built-in Gain (24)			3,400,000.00
cr		Jane Smith-Built-in Gain (26)			3,400,000.00
dr		Current Distributed UGL (21)		6,800,000.00	
5	Dec 15 04	Gift of Units (1)	C		
memo		\$22,000 per child - 2004			
dr		John Smith-Built-in Gain (24)		27,365.85	
dr		Jane Smith-Built-in Gain (26)		27,365.85	
cr		Mike Smith-Built-in Gain (7)			18,243.90
cr		Mike Smith-Tax Basis (6)			3,756.10
cr		Kim Smith-Built-in Gain (9)			18,243.90
cr		Kim Smith-Tax Basis (8)			3,756.10
cr		Steve Smith-Built-in Gain (11)			18,243.90
cr		Steve Smith-Tax Basis (10)			3,756.10
dr		John Smith-Tax Basis (23)		5,634.15	
dr		Jane Smith-Tax Basis (25)		5,634.15	

Total Credits: 5 Items

Dec 31 04 Ending Balance

Summary by Account

Total by Account

Summary of Distributions

CASH (19)	200,000.00
Current Distributed UGL (21)	6,800,000.00
D. Lloyd-Tax Basis (4)	200,000.00
Jane Smith-Built-in Gain (26)	3,372,634.15
Jane Smith-Tax Basis (25)	594,365.85
John Smith-Built-in Gain (24)	3,372,634.15
John Smith-Tax Basis (23)	594,365.85

**Smith Land Development, LLC
Transactions with Distributions
General Journal (12)
From: January 2004 To: December 2004**

<u>JE #</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Status</u>	<u>dr</u>	<u>cr</u>
		Kim Smith-Built-in Gain (9)			18,243.90
		Kim Smith-Tax Basis (8)			3,756.10
		LAND (18)		8,000,000.00	
		Mike Smith-Built-in Gain (7)			18,243.90
		Mike Smith-Tax Basis (6)			3,756.10
		Steve Smith-Built-in Gain (11)			18,243.90
		Steve Smith-Tax Basis (10)			3,756.10
		Unrealized Gains or Losses (1)			6,800,000.00
		Total of Distributions			.00

Smith Land Development, LLC
Transactions with Distributions
General Journal (12)
From: January 2005 To: December 2005

<u>JE #</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Status</u>	<u>dr</u>	<u>cr</u>
	Jan 1 05	Beginning Balance			
6	Jan 15 05	Gift of Units (1)	C		
dr		John Smith-Built-in Gain (40)		27,365.85	
dr		John Smith-Tax Basis (39)		5,634.15	
dr		Jane Smith-Built-in Gain (45)		27,365.85	
dr		Jane Smith-Tax Basis (44)		5,634.15	
cr		Mike Smith-Built-in Gain (7)			18,243.90
cr		Mike Smith-Tax Basis (6)			3,756.10
cr		Kim Smith-Built-in Gain (9)			18,243.90
cr		Kim Smith-Tax Basis (8)			3,756.10
cr		Steve Smith-Built-in Gain (11)			18,243.90
cr		Steve Smith-Tax Basis (10)			3,756.10
7	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)	C		
dr		Current Year Allocated Inc (20)		1,700,000.00	
cr		John Smith-Capital Gains (41)			835,975.00
cr		Jane Smith-Capital Gains (46)			835,975.00
cr		Mike Smith-Capital Gains (26)			9,350.00
cr		Kim Smith-Capital Gains (27)			9,350.00
cr		Steve Smith-Capital Gains (28)			9,350.00
8	Mar 31 05	Distribute UGL/Smiths (6)	C		
cr		Current Distributed UGL (21)			1,700,000.00
dr		John Smith-Built-in Gain (40)		835,975.00	
dr		Jane Smith-Built-in Gain (45)		835,975.00	
dr		Mike Smith-Built-in Gain (7)		9,350.00	
dr		Kim Smith-Built-in Gain (9)		9,350.00	
dr		Steve Smith-Built-in Gain (11)		9,350.00	
9	Dec 31 05	Distribute Investment Inc/All Partners (11)	C		
dr		Current Year Allocated Inc (20)		60,000.00	
cr		John Smith-Investment Inc (42)			28,785.37
cr		Jane Smith-Investment Inc (47)			28,785.37
cr		D. Lloyd-Investment Inc (30)			1,463.41
cr		Mike Smith-Investment Inc (31)			321.95
cr		Kim Smith-Investment Inc (32)			321.95
cr		Steve Smith-Investment Inc (33)			321.95

Total Credits: 4 Items

Dec 31 05 Ending Balance

Summary by Account

Total by Account

Summary of Distributions

Current Distributed UGL (21)		1,700,000.00
Current Year Allocated Inc (20)	1,760,000.00	
D. Lloyd-Investment Inc (30)		1,463.41
Jane Smith-Built-in Gain (45)	863,340.85	

**Smith Land Development, LLC
Transactions with Distributions
General Journal (12)
From: January 2005 To: December 2005**

<u>JE #</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Status</u>	<u>dr</u>	<u>cr</u>
		Jane Smith-Capital Gains (46)			835,975.00
		Jane Smith-Investment Inc (47)			28,785.37
		Jane Smith-Tax Basis (44)		5,634.15	
		John Smith-Built-in Gain (40)		863,340.85	
		John Smith-Capital Gains (41)			835,975.00
		John Smith-Investment Inc (42)			28,785.37
		John Smith-Tax Basis (39)		5,634.15	
		Kim Smith-Built-in Gain (9)			8,893.90
		Kim Smith-Capital Gains (27)			9,350.00
		Kim Smith-Investment Inc (32)			321.95
		Kim Smith-Tax Basis (8)			3,756.10
		Mike Smith-Built-in Gain (7)			8,893.90
		Mike Smith-Capital Gains (26)			9,350.00
		Mike Smith-Investment Inc (31)			321.95
		Mike Smith-Tax Basis (6)			3,756.10
		Steve Smith-Built-in Gain (11)			8,893.90
		Steve Smith-Capital Gains (28)			9,350.00
		Steve Smith-Investment Inc (33)			321.95
		Steve Smith-Tax Basis (10)			3,756.10
		Total of Distributions			.00

Smith Land Development, LLC
Transactions with Distributions
Checking Account (22)
From: January 2005 To: December 2005

<u>Chk #</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Status</u>	<u>dr</u>	<u>cr</u>
	Jan 1 05	Beginning Balance			
Dr	Mar 31 05	Sell Land (4)	C		
memo	Mar 31 05	Sold Qty 30			
memo		Tax Basis 300,000.00			
cr		LAND (18)			2,000,000.00
cr		Capital Gains-Long Term (16)			2,700,000.00
dr		Unrealized Gains or Losses (1)		1,700,000.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)	C		
dr		Current Year Allocated Inc (20)		1,000,000.00	
cr		John Smith-Capital Gains (41)			479,756.00
cr		Jane Smith-Capital Gains (46)			479,756.00
cr		D. Lloyd-Capital Gains (25)			24,390.00
cr		Mike Smith-Capital Gains (26)			5,366.00
cr		Kim Smith-Capital Gains (27)			5,366.00
cr		Steve Smith-Capital Gains (28)			5,366.00
Dr	Dec 1 05	Interest Income (8)	C		
cr		Interest Income-Taxable (13)			60,000.00
Cr	Dec 31 05	Cash Distribution/All Partners (10)	C		
dr		John Smith-Cash Dist (43)		479,756.10	
dr		Jane Smith-Cash Dist (48)		479,756.10	
dr		D. Lloyd-Cash Dist (35)		24,390.25	
dr		Kim Smith-Cash Dist (37)		5,365.85	
dr		Mike Smith-Cash Dist (36)		5,365.85	
dr		Steve Smith-Cash Dist (38)		5,365.85	
<u>Summary of Distributions</u>					
		Capital Gains-Long Term (16)			2,700,000.00
		Current Year Allocated Inc (20)		1,000,000.00	
		D. Lloyd-Capital Gains (25)			24,390.00
		D. Lloyd-Cash Dist (35)		24,390.25	
		Interest Income-Taxable (13)			60,000.00
		Jane Smith-Capital Gains (46)			479,756.00
		Jane Smith-Cash Dist (48)		479,756.10	
		John Smith-Capital Gains (41)			479,756.00
		John Smith-Cash Dist (43)		479,756.10	
		Kim Smith-Capital Gains (27)			5,366.00
		Kim Smith-Cash Dist (37)		5,365.85	
		LAND (18)			2,000,000.00
		Mike Smith-Capital Gains (26)			5,366.00
		Mike Smith-Cash Dist (36)		5,365.85	
		Steve Smith-Capital Gains (28)			5,366.00
		Steve Smith-Cash Dist (38)		5,365.85	
		Unrealized Gains or Losses (1)		1,700,000.00	
		Total of Distributions			2,060,000.00

Smith Land Development, LLC
Detail Trial Balance
From: January 2005 To: December 2005

<u>ID</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Begin Balance</u>	<u>Chg in Acct Bal</u>	<u>Activity</u>	<u>Ending Balance</u>
<u>EQUITY(-)</u>						
		John Smith-Tax Basis (39)	-594,365.85	.00		
6	Jan 15 05	Gift of Units (1)			5,634.15	
		Total			5,634.15	-588,731.70
		John Smith-Built-in Gain (40)	-3,372,634.15	.00		
6	Jan 15 05	Gift of Units (1)			27,365.85	
8	Mar 31 05	Distribute UGL/Smiths (6)			835,975.00	
		Total			863,340.85	-2,509,293.30
		John Smith-Capital Gains (41)		.00	.00	
Cr	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			-835,975.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-479,756.00	
		Total			-1,315,731.00	-1,315,731.00
		John Smith-Investment Inc (42)		.00	.00	
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-28,785.37	
		Total			-28,785.37	-28,785.37
		John Smith-Cash Dist (43)		.00	.00	
Dr	Dec 31 05	Cash Distribution/All Partners (10)			479,756.10	
		Total			479,756.10	479,756.10
		Jane Smith-Tax Basis (44)	-594,365.85	.00		
6	Jan 15 05	Gift of Units (1)			5,634.15	
		Total			5,634.15	-588,731.70
		Jane Smith-Built-in Gain (45)	-3,372,634.15	.00		
6	Jan 15 05	Gift of Units (1)			27,365.85	
8	Mar 31 05	Distribute UGL/Smiths (6)			835,975.00	
		Total			863,340.85	-2,509,293.30
		Jane Smith-Capital Gains (46)		.00	.00	
Cr	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			-835,975.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-479,756.00	
		Total			-1,315,731.00	-1,315,731.00
		Jane Smith-Investment Inc (47)		.00	.00	
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-28,785.37	
		Total			-28,785.37	-28,785.37
		Jane Smith-Cash Dist (48)		.00	.00	
Dr	Dec 31 05	Cash Distribution/All Partners (10)			479,756.10	
		Total			479,756.10	479,756.10

Prepared by Financial Navigator (R)

**Smith Land Development, LLC
Detail Trial Balance
From: January 2005 To: December 2005**

<u>ID</u>	<u>Date</u>	<u>Payee/Payor</u>	<u>Begin Balance</u>	<u>Chg in Acct Bal</u>	<u>Activity</u>	<u>Ending Balance</u>
		D. Lloyd-Tax Basis (4)	-200,000.00	.00	.00	-200,000.00
		D. Lloyd-Built-in Gain (5)	.00	.00	.00	.00
		D. Lloyd-Capital Gains (25)	.00	.00		
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-24,390.00	
		Total			-24,390.00	-24,390.00
		D. Lloyd-Investment Inc (30)	.00	.00		
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-1,463.41	
		Total			-1,463.41	-1,463.41
		D. Lloyd-Cash Dist (35)	.00	.00		
Dr	Dec 31 05	Cash Distribution/All Partners (10)			24,390.25	
		Total			24,390.25	24,390.25
		Mike Smith-Tax Basis (6)	-3,756.10	.00		
Cr	Jan 15 05	Gift of Units (1)			-3,756.10	
		Total			-3,756.10	-7,512.20
		Mike Smith-Built-in Gain (7)	-18,243.90	.00		
Cr	Jan 15 05	Gift of Units (1)			-18,243.90	
8	Mar 31 05	Distribute UGL/Smiths (6)			9,350.00	
		Total			-8,893.90	-27,137.80
		Mike Smith-Capital Gains (26)	.00	.00		
Cr	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			-9,350.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-5,366.00	
		Total			-14,716.00	-14,716.00
		Mike Smith-Investment Inc (31)	.00	.00		
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-321.95	
		Total			-321.95	-321.95
		Mike Smith-Cash Dist (36)	.00	.00		
Dr	Dec 31 05	Cash Distribution/All Partners (10)			5,365.85	
		Total			5,365.85	5,365.85
		Kim Smith-Tax Basis (8)	-3,756.10	.00		
Cr	Jan 15 05	Gift of Units (1)			-3,756.10	
		Total			-3,756.10	-7,512.20
		Kim Smith-Built-in Gain (9)	-18,243.90	.00		
Cr	Jan 15 05	Gift of Units (1)			-18,243.90	
8	Mar 31 05	Distribute UGL/Smiths (6)			9,350.00	
		Total			-8,893.90	-27,137.80

**Smith Land Development, LLC
Detail Trial Balance
From: January 2005 To: December 2005**

ID	Date	Payee/Payor	Begin Balance	Chg in Acct Bal	Activity	Ending Balance
		Kim Smith-Capital Gains (27)	.00	.00		
Cr	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			-9,350.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-5,366.00	
		Total			-14,716.00	-14,716.00
		Kim Smith-Investment Inc (32)	.00	.00		
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-321.95	
		Total			-321.95	-321.95
		Kim Smith-Cash Dist (37)	.00	.00		
Dr	Dec 31 05	Cash Distribution/All Partners (10)			5,365.85	
		Total			5,365.85	5,365.85
		Steve Smith-Tax Basis (10)	-3,756.10	.00		
Cr	Jan 15 05	Gift of Units (1)			-3,756.10	
		Total			-3,756.10	-7,512.20
		Steve Smith-Built-in Gain (11)	-18,243.90	.00		
Cr	Jan 15 05	Gift of Units (1)			-18,243.90	
8	Mar 31 05	Distribute UGL/Smiths (6)			9,350.00	
		Total			-8,893.90	-27,137.80
		Steve Smith-Capital Gains (28)	.00	.00		
Cr	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			-9,350.00	
Cr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			-5,366.00	
		Total			-14,716.00	-14,716.00
		Steve Smith-Investment Inc (33)	.00	.00		
Cr	Dec 31 05	Distribute Investment Inc/All Partners (11)			-321.95	
		Total			-321.95	-321.95
		Steve Smith-Cash Dist (38)	.00	.00		
Dr	Dec 31 05	Cash Distribution/All Partners (10)			5,365.85	
		Total			5,365.85	5,365.85
		Current Year Allocated Inc (20)	.00	.00		
7	Mar 31 05	Distribute Tax Basis Gain/Smiths (9)			1,700,000.00	
Dr	Mar 31 05	Distribute Book Basis Gain/All Partners (7)			1,000,000.00	
9	Dec 31 05	Distribute Investment Inc/All Partners (11)			60,000.00	
		Total			2,760,000.00	2,760,000.00
		Current Distributed UGL (21)	6,800,000.00	.00		
Cr	Mar 31 05	Distribute UGL/Smiths (6)			-1,700,000.00	
		Total			-1,700,000.00	5,100,000.00

**Smith Land Development, LLC
Detail Trial Balance
From: January 2005 To: December 2005**

ID	Date	Payee/Payor	Begin Balance	Chg in Acct Bal	Activity	Ending Balance
		Prior Year Allocated Inc (49)	.00	.00	.00	.00
		TOTAL EQUITY(-)	-1,400,000.00	.00	1,000,000.00	-400,000.00
		<u>EQUITY(-)</u>				
		EQUITY-Beginning(-)	.00			.00
		Net Income-Prior Years(-)	.00			.00
		Net Income-Current Year(-)	.00	.00	-2,760,000.00	-2,760,000.00
		Unrealized Gains or Losses (1)	-6,800,000.00	.00		
Dr	Mar 31 05	Sell Land (4)			1,700,000.00	
memo	Mar 31 05	Sold Qty 30				
memo		Tax Basis300,000.00				
		Total			1,700,000.00	-5,100,000.00
		Changes in Account Bal(-)	.00	.00		.00
		TOTAL EQUITY(-)	-6,800,000.00	.00	-1,060,000.00	-7,860,000.00
		TOTAL	.00	.00	.00	.00

Smith Land Development, LLC
Balance Sheet-Starting Balances
As of: January 01, 2006

	<u>Balance</u>
<u>ASSETS</u>	
CURRENT ASSETS	
Cash on Hand:	
CASH	200,000
Total Cash on Hand:	200,000
Checking Accounts:	
Checking Account	2,060,000
Total Checking Accounts:	2,060,000
TOTAL CURRENT ASSETS	2,260,000
LONG-TERM INVESTMENTS	
Undeveloped Land:	
LAND	6,000,000
Total Undeveloped Land:	6,000,000
TOTAL LONG-TERM INVESTMENTS	6,000,000
TOTAL ASSETS	8,260,000

<u>EQUITY</u>	
OWNERS' EQUITY	
John Smith:	
John Smith-Tax Basis	1,453,492
John Smith-Built-in Gain	2,509,293
Total John Smith:	3,962,785
Jane Smith:	
Jane Smith-Tax Basis	1,453,492
Jane Smith-Built-in Gain	2,509,293
Total Jane Smith:	3,962,785
D. Lloyd:	
D. Lloyd-Tax Basis	201,463
Total D. Lloyd:	201,463
Mike Smith:	
Mike Smith-Tax Basis	17,184
Mike Smith-Built-in Gain	27,138
Total Mike Smith:	44,322
Kim Smith:	
Kim Smith-Tax Basis	17,184
Kim Smith-Built-in Gain	27,138
Total Kim Smith:	44,322
Steve Smith:	

**Smith Land Development, LLC
Balance Sheet-Starting Balances
As of: January 01, 2006**

	<u>Balance</u>
Steve Smith-Tax Basis	17,184
Steve Smith-Built-in Gain	27,138
Total Steve Smith:	44,322
Allocated Income:	
Current Distributed UGL	-5,100,000
Prior Year Allocated Inc	-2,760,000
Total Allocated Income:	-7,860,000
TOTAL OWNERS' EQUITY	399,999
Net Income-Prior Years	2,760,000
Net Income-Current Year	0
Unrealized Gains or Losses	5,100,000
TOTAL EQUITY	8,260,000
TOTAL LIABILITIES AND EQUITY	8,260,000