PacificCPE

Fundamentals of Partnership Taxation

Course #33051B

Taxes

2 Credit Hours

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FUNDAMENTALS OF PARTNERSHIP TAXATION

This course provides an introduction to partnership taxation, outlining the key advantages and disadvantages of forming a partnership. It reviews the relevant sections of the Internal Revenue Code that govern partnership taxation and explains the characteristics of general and limited partnership interests. The course offers foundational knowledge for understanding how partnerships are structured and taxed.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

What Is a Partnership?
Partnership Formation and Computation of Partner Basis
Receipt of a Partnership Interest for Services

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Identify the advantages and disadvantages of a partnership.
- Recall the portion of the Internal Revenue Code that governs partnership taxation.
- Recognize the characteristics of the two types of partnership interests.

NOTICE

Program publication date **10/7/25**

EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: WHAT IS A PARTNERSHIP?

Chapter Objective

After completing this chapter, you should be able to:

- Identify the advantages and disadvantages of a partnership.

¶101 INTRODUCTION

For legal purposes a business activity may be conducted in various forms, ranging from a sole proprietorship to a partnership to a corporation. Along that continuum, a jointly held activity can be conducted as a tenancy in common, a general partnership, a limited partnership, a limited liability company, a limited liability partnership, a limited liability limited partnership, a professional corporation, a C corporation, or a publicly traded partnership. The array of available entities in which a business can operate is more diverse than ever, and taxpayers should consider both tax and nontax considerations when selecting the entity for their business.

A partnership is an association between two or more persons who join to carry on a trade or business for profit. Each person contributes money, property, labor or skill, and expects to share in the profits and losses of the business. As indicated above, the laws of different states provide for several different kinds of partnerships. A *general partnership* is one in which every partner has unlimited liability for the debts of the partnership. A *limited partnership* is one in which at least one partner's liability for the debts of the partnership is limited to that partner's investment in the partnership. Any partner with such limited liability is a limited partner, and any partner with unlimited liability is a general partner. One condition for a partner to be eligible for limited liability, however, is that the partner is not allowed to have any impact in the decision-making process. Only general partners can participate in the management of the partnership.

A *limited liability partnership* (LLP) is a type of general partnership in which each of the partners (all of whom are general partners) is protected from personal liability for negligent acts committed by other partners or by employees not under his or her direct control. Some states go even further, allowing general partners in an LLP essentially the same protection as limited partners in a limited partnership. The use of this type of partnership is often restricted to professional partnerships such as law firms and accounting firms. Essentially, use of an LLP allows partners in these firms to avoid personal liability for errors in judgment made by other partners. A partner in an LLP may lose the capital invested in the partnership, but does not risk assets outside the partnership unless the firm incurs liability for losses incurred as a result of that specific partner's behavior.

A *limited liability limited partnership* (LLLP) is generally a limited partnership that elects to become an LLP as well, thus affording the general partners the same protection from liability as an LLP. A *limited liability company* (LLC) is an extremely popular type of entity whose owners can all participate in the management of the business, but who also are all given protection from the liabilities of the LLC (except to the extent of their investment in the LLC). Although not legally a partnership, most LLCs elect to be treated as partnerships for tax purposes.

Just because an entity is *legally* a partnership does not mean that it will be taxed as a partnership. The legal treatment of an entity is determined under state and local laws, while the federal income tax treatment is determined under the federal income tax laws. Often a business will be treated as the same type of entity for both federal income tax purposes and legal purposes, but, in some cases, a business entity will be treated differently for legal vs. tax purposes. A business that is classified as a partnership under state law, for example, can elect to be treated as a corporation for federal income tax purposes, if the owners do not want it to be taxed as a partnership. In addition, joint owners of property may be classified as tenants-in-common for legal purposes but as a partnership for federal income tax purposes.

It should also be noted that while the income tax system defines certain categories of entities that exist only for income tax purposes, such as S corporations, many types of legal entities do not have a separate, specifically defined counterpart for income tax purposes. Limited liability companies and limited liability partnerships, for example, exist under state law but are usually treated for federal income tax purposes much the same as any partnership would be. This is true even though they share many characteristics with corporations (*e.g.*, limited liability, unlimited life, etc.).

There are three general sets of regulatory rules that classify entities as a partnership for tax purposes versus something other than a partnership (*e.g.*, a corporation, trust or sole proprietorship):

1. The rules which are commonly referred to as the “check-the-box” classification rules;[1]
2. The “anti-abuse” rules;[2] and
3. Rules which allow investment joint venturers to choose whether to be partnerships or tenancies-in-common.[3]

The check-the-box regulations are by far the most important of these. The check-the-box rules allow taxpayers to choose whether to treat partnerships and other unincorporated entities (*e.g.,* LLCs) as either corporations or partnerships for federal income tax purposes. The anti-abuse rules allow the IRS (rather than the taxpayer) to recharacterize something the taxpayer is treating as a partnership as something other than a partnership. The third rule allows simple partnerships that resemble jointly owned investments to elect to treat themselves not as partnerships, but as tenants-in-common for tax purposes.

In addition, there is substantive case law distinguishing a partnership from other business arrangements, such as debtor-creditor or employee-employer relationships.

1. Reg. §§301.7701-1, -2, and -3.
2. Reg. § 1.701-2.
3. Reg. § 1.761-2.

¶102 CLASSIFICATION OF PARTNERSHIPS

The "check-the-box" regulations are so called because the entity can choose its tax classification by checking a certain box on Form 8832, *Entity Classification Election*, and filing Form 8832 with the appropriate IRS Service Center. Generally, an election specifying an entity's classification cannot take effect more than 75 days prior to the date the election is filed, nor can it take effect later than 12 months after the date the election is filed. The check-the-box regulations allow considerable flexibility in what entity a business chooses for federal income tax purposes, with one exception: a business activity *incorporated* under the law of any state, federal, or foreign jurisdiction must be treated as a corporation for federal income tax purposes.[4] If the shareholders of that corporation prefer a tax treatment similar to a partnership, then they should make an S election. However, the fact that the business is incorporated under state law will make it impossible for it to choose to be treated as a partnership for federal income tax purposes.

For unincorporated entities, the check-the-box regulations allow much more flexibility. While the default classification of unincorporated entities is usually to be treated as a partnership, a jointly owned, *unincorporated*, profit-motivated domestic business entity (such as a limited liability company or partnership) may elect to be a corporation for tax purposes.

Example 1-1

EXAMPLE

Clara and Ernie Majors are married and own a hardware store. Ernie operates the hardware store. He reports the tax results on Schedule C, Form 1040. The Majors would like to form an S corporation for federal income tax purposes, but they do not want the trouble and expense of incorporating and following the other corporate formalities. Clara and Ernie enter into a partnership, contributing the hardware business and all related assets to the partnership. The partnership files Form 8832, indicating that it elects to be a corporation for federal income tax purposes. It then files Form 2553, Election by a Small Business Corporation, and thereby elects to be treated as an S corporation for tax purposes. By electing to be classified as an S corporation, pass-through income (in excess of reasonable compensation) will not be subject to the self-employment or Medicare taxes.

If an eligible unincorporated organization does not elect to be a corporation, then it is by default a partnership for tax purposes. As a partnership, the organization will be required to file a Form 1065, U.S. Return of Partnership Income, each year by the 15th day of the third month after the close of the taxable year. For calendar year partnerships, this means that the Form 1065 must be filed by March 15 of the following year.[5] A partnership is allowed an automatic six-month extension of the time allowed for filing Form 1065. The extension application must be made on Form 7004 and it must be filed by the unextended due date of the Form 1065, but it does not have to contain a reason for the requested extension.[6]

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4. Reg. § 301.7701-3.
5. Code Sec. 6072(a) and (b).
6. Reg. § 1.6081-2T.