PacificCPE

COURSE
30251B

Partnership Taxation: A Complete Overview

Get a comprehensive introduction to partnership taxation covering everything from formation to termination. This course walks through key issues including partnership returns (Form 1065), distributions, partner basis, dispositions of partnership interests, and transactions between partnerships and partners. You'll also explore exclusions from partnership rules and Section 1061 reporting requirements. Whether you're new to partnership taxation or looking to sharpen your knowledge across the full lifecycle of a partnership, this course provides a solid, practical foundation.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize how the income tax law applies to partnerships, as well as partners.
- Identify which partnership items partners must include on their partnership return.

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PARTNERSHIP GENERAL TAX INFORMATION

Chapter Objective

After completing this chapter, you should be able to:

- Recognize how the income tax law applies to partnerships, as well as partners.
- Identify which partnership items partners must include on their partnership return.

I. INTRODUCTION

This chapter explains how the income tax law applies to partnerships and to partners. Generally, a partnership does not pay tax on its income but "passes through" any profits or losses to its partners. Partners must include partnership items on their tax returns.

II. IMPORTANT ISSUES

Withholding on foreign partner or firm. A partnership that has foreign partners or engages in certain transactions with foreign persons may have one (or more) of the following obligations.

Fixed or determinable annual or periodical (FDAP) income. A partnership may have to withhold tax on distributions to a foreign partner or a foreign partner's distributive share when it earns income not effectively connected with a U.S. trade or business. A partnership may also have to withhold on payments to a foreign person of FDAP income not effectively connected with a U.S. trade or business.

Withholding under the Foreign Investment in Real Property Tax Act (FIRPTA). If a partnership acquires a U.S. real property interest from a foreign person or firm, the partnership may have to withhold tax on the amount it pays for the property (including cash, the fair market value of other property, and any assumed liability).

Withholding on foreign partner's effectively connected taxable income (ECTI). If a partnership has income effectively connected with a trade or business in the United States (including gain on the disposition of a U.S. real property interest), it must withhold on the ECTI allocable to its foreign partners.

Withholding on foreign partner's sale of a partnership interest. Apurchaser of a partnership interest, which may include the partnership itself, may have to withhold tax on the amount realized by a foreign partner on the sale for that partnership interest if the partnership is engaged in a trade or business in the United States.

Withholding under the Foreign Account Tax Compliance Act (FATCA). A partnership may have to withhold tax on distributions to a foreign partner of a foreign partner's distributive share when it earns withholdable payments. Apartnership may also have to withhold on withholdable payments that it makes to a foreign entity. A partnership that has a duty to withhold but fails to withhold may be held liable for the tax, applicable penalties, and interest.

III. FORMING A PARTNERSHIP

The following sections contain general information about partnerships.

ORGANIZATIONS CLASSIFIED AS PARTNERSHIPS

An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits. However, a joint undertaking merely to share expenses is not a partnership. For example, co-ownership of property maintained and rented or leased is not a partnership unless the co-owners provide services to the tenants.

The rules you must use to determine whether an organization is classified as a partnership changed for organizations formed after 1996.

Organizations formed after 1996. An organization formed after 1996 is classified as a partnership for federal tax purposes if it has two or more members and it is none of the following.

- An organization formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic.
- An organization formed under a state law that refers to it as a joint-stock company or joint-stock association.
- An insurance company.
- Certain banks.
- An organization wholly owned by a state, local, or foreign government.
- An organization specifically required to be taxed as a corporation by the Internal Revenue Code (for example, certain publicly traded partnerships).
- Certain foreign organizations identified in section 301.7701-2(b)(8) of the regulations.
- A tax-exempt organization.
- A real estate investment trust.
- An organization classified as a trust under section 301.7701-4 of the regulations or otherwise subject to special treatment under the Internal Revenue Code.
- Any other organization that elects to be classified as a corporation by filing Form 8832.

Limited liability company. A limited liability company (LLC) is an entity formed under state law by filing articles of organization as an LLC. Unlike a partnership, none of the members of an LLC are personally liable for its debts. An LLC may be classified for federal income tax purposes as either a partnership, a corporation, or an entity disregarded as an entity separate from its owner by applying the rules in regulations section 301.7701-3.

Tip

A domestic LLC with at least two members that does not file Form 8832 is classified as a partnership for federal income tax purposes.

Organizations formed before 1997. An organization formed before 1997 and classified as a partnership under the old rules will generally continue to be classified as a partnership as long as the organization has at least two members and does not elect to be classified as a corporation by filing Form 8832.

Community property. Spouses who own a qualified entity (defined later) can choose to classify the entity as a partnership for federal tax purposes by filing the appropriate partnership tax returns. They can choose to classify the entity as a sole proprietorship by filing a Schedule C (Form 1040) listing one spouse as the sole proprietor. A change in reporting position will be treated for federal tax purposes as a conversion of the entity.

A **qualified entity** is a business entity that meets all the following requirements.

- The business entity is wholly owned by spouses as community property under the laws of a state, a foreign country, or a possession of the United States.
- No person other than one or both spouses would be considered an owner for federal tax purposes.
- The business entity is not treated as a corporation.

Partnership Interests Created by Gift

Gift of capital interest. If a family member (or any other person) receives a gift of a capital interest in a partnership in which capital is a material income-producing factor, the donee's distributive share of partnership income is subject to both of the following restrictions.

- It must be figured by reducing the partnership income by reasonable compensation for services the donor renders to the partnership.
- The donee's distributive share of partnership income attributable to donated capital must not be proportionately greater than the donor's distributive share attributable to the donor's capital.

Purchase considered gift. For purposes of determining a partner's distributive share, an interest purchased by one family member from another family member is considered a gift from the seller. The FMV of the purchased interest is considered donated capital. For this purpose, members of a family include only spouses, ancestors, and lineal descendants (or a trust for the primary benefit of those persons).

Partnership Interests Held in Connection with Performance of Services

Section 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. The provision generally requires that a capital asset be held for more than 3 years for capital gain and loss allocated with respect to any applicable partnership interest (API) to be treated as long-term capital gain or loss. Proposed Regulations (REG- 107213-18) were published in the Federal Register on August 14, 2020. Final regulations (Treasury Decision 9945) were published in the Federal Register on January 19, 2021. Treasury Decision 9945, 2021-5 I.R.B. 627, is available at IRS.gov/irb/2021-5_IRB#TD-9945. Owner taxpayers and pass-through entities may rely on the proposed regulations for tax years beginning before January 19, 2021 (the date final regulations were published in the Federal Register), provided they follow the proposed regulations in their entirety and in a consistent manner. An owner taxpayer or pass-through entity may choose to apply the final regulations to a tax year beginning after December 31, 2017, provided that they consistently apply the final section 1061 regulations in their entirety to that year and all subsequent years. Owner taxpayers and pass-through entities must apply the final regulations to tax years beginning on or after January 19, 2021.

Applicable trade or business. An applicable trade or business means any activity conducted on a regular, continuous, and substantial basis (regardless of whether the activity is conducted through one or more entities) which consists in whole or in part of raising or returning capital, and either:

- Investing in or disposing of "specific assets" (or identifying specified assets for investing or disposition), or
- Developing specified assets.

Specified assets. Specified assets are:

- Securities (as defined in Internal Revenue Code section 475(c)(2), under rules for mark- to-market accounting for securities dealers),
- Commodities (as defined under rules for mark-to-market accounting for commodities dealers in Internal Revenue Code section 475(e)(2)),
- Real estate held for rental or investment,
- Options or derivative contracts with respect to such securities,
- Cash or cash equivalents, or

- An interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

Security. A security for this purpose means any of the following.

- Share of corporate stock.
- Partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust.
- Note, bond, debenture, or other evidence of indebtedness.
- Interest rate, currency, or equity notional principal contract.
- Interest in, or derivative financial instrument in, any such security or any currency (regardless of whether Internal Revenue Code section 1256 applies to the contract).
- Position that is not such a security and is a hedge with respect to such a security and is clearly identified.

Business owned and operated by spouses. If spouses carry on a business together and share in the profits and losses, they may be partners whether or not they have a formal partnership agreement. If so, they should report income or loss from the business on Form 1065. They should not report the income on a Schedule C (Form 1040) in the name of one spouse as a sole proprietor. However, the spouses can elect not to treat the joint venture as a partnership by making a qualified joint venture election.

Qualified Joint Venture Election. A "qualified joint venture," whose only members are spouses filing a joint return, can elect not to be treated as a partnership for federal tax purposes. A qualified joint venture conducts a trade or business where the only members of the joint venture are spouses filing jointly; both spouses elect not to be treated as a partnership; both spouses materially participate in the trade or business; and the business is co-owned by both spouses and is not held in the name of a state law entity such as a partnership or LLC.

Under this election, a qualified joint venture conducted by spouses who file a joint return is not treated as a partnership for federal tax purposes and therefore does not have a Form 1065 filing requirement. All items of income, gain, deduction, loss, and credit are divided between the spouses based on their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Each spouse would account for his or her respective share on the appropriate form, such as Schedule C (Form 1040). For purposes of determining net earnings from self-employment, each spouse's share of income or loss from a qualified joint venture is taken into account just as it is for federal income tax purposes (i.e., based on their respective interests in the venture).

If the spouses do not make the election to treat their respective interests in the joint venture as sole proprietorships, each spouse should carry his or her share of the partnership income or loss from

Schedule K1 (Form 1065) to their joint or separate Form(s) 1040. Each spouse should include his or her respective share of self-employment income on a separate Schedule SE (Form 1040), *Self-Employment Tax*.

This generally does not increase the total tax on the return, but it does give each spouse credit for social security earnings on which retirement benefits are based. However, this may not be true if either spouse exceeds the social security tax limitation.

PARTNERSHIP AGREEMENT

The partnership agreement includes the original agreement and any modifications. The modifications must be agreed to by all partners or adopted in any other manner provided by the partnership agreement. The agreement or modifications can be oral or written.

Partners can modify the partnership agreement for a particular tax year after the close of the year but not later than the date for filing the partnership return for that year. This filing date does not include any extension of time.

If the partnership agreement or any modification is silent on any matter, the provisions of local law are treated as part of the agreement.

IV. TERMINATING A PARTNERSHIP

A partnership terminates when all its operations are discontinued and no part of any business, financial operation, or venture is continued by any of its partners in a partnership.

Date of termination. The partnership's tax year ends on the date of termination. The date of termination is the date the partnership completes the winding up of its affairs.

Short period return. If a partnership is terminated before the end of what would otherwise be its tax year, Form 1065 must be filed for the short period, which is the period from the beginning of the tax year through the date of termination. The return is due the 15th day of the 3rd month following the date of termination. See Partnership Return (Form 1065), later, for information about filing Form 1065.

Conversion of partnership into limited liability company (LLC). The conversion of a partnership into an LLC classified as a partnership for federal tax purposes does not terminate the partnership. The conversion is not a sale, exchange, or liquidation of any partnership interest, the partnership's tax year does not close, and the LLC can continue to use the partnership's taxpayer identification number (TIN).

However, the conversion may change some of the partners' bases in their partnership interests if the partnership has recourse liabilities that become nonrecourse liabilities. Because the partners share recourse and nonrecourse liabilities differently, their bases must be adjusted to reflect the

new sharing ratios. If a decrease in a partner's share of liabilities exceeds the partner's basis, he or she must recognize gain on the excess. For more information, see *Effect of Partnership Liabilities under Basis of Partner's Interest*, later.

The same rules apply if an LLC classified as a partnership is converted into a partnership.

ELECTRONIC FILING

Certain partnerships that: (a) have more than 100 partners, or (b) are required by the Code or regulations to file at least 10 returns during the calendar year ending with or within the tax year of the partnership, are required to file Form 1065, Schedules K-1, and related forms and schedules electronically). For the tax years beginning after July 1, 2019, a religious or apostolic organization exempt from income tax under section 501(d) must file Form 1065 electronically. Other partnerships generally have the option to file electronically. For details about electronic filing, see the Form 1065 instructions.

V. EXCLUSION FROM PARTNERSHIP RULES

Certain partnerships that do not actively conduct a business can choose to be completely or partially excluded from being treated as partnerships for federal income tax purposes. All the partners must agree to make the choice, and the partners must be able to compute their own taxable income without figuring the partnership's income. However, the partners are not exempt from the rule that limits a partner's distributive share of partnership loss to the adjusted basis of the partner's partnership interest. Nor are they exempt from the requirement of a business purpose for adopting a tax year for the partnership that differs from its required tax year.

Investing partnership. An investing partnership can be excluded if the participants in the joint purchase, retention, sale, or exchange of investment property meet all the following requirements.

- They own the property as co-owners.
- They reserve the right separately to take or dispose of their shares of any property acquired or retained.
- They do not actively conduct business or irrevocably authorize some person acting in a representative capacity to purchase, sell, or exchange the investment property. Each separate participant can delegate authority to purchase, sell, or exchange his or her share of the investment property for the time being for his or her account, but not for a period of more than a year.

Operating agreement partnership. An operating agreement partnership group can be excluded if the participants in the joint production, extraction, or use of property meet all the following requirements.