PacificCPE

COURSE

33051C

Partnerships: Fundamentals and Basis

Get grounded in the essentials of partnership taxation. This course covers what qualifies as a partnership, how partnerships differ from other business entities, and the rules governing partnership formation. You'll also work through the computation of partner basis—a foundational skill for anyone advising clients who hold partnership interests. Comparisons to S corporations are woven throughout, making this a practical starting point for tax professionals looking to strengthen or refresh their partnership knowledge.

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

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Final Exam Copy ↓

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

- Identify the advantages and disadvantages of a partnership.
- Recall the portion of the Internal Revenue Code that governs partnership taxation.
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TABLE OF CONTENTS

CHAPTER 01

What Is A Partnership? 4

1.01 101 Introduction 4

1.02 103 Advantages And Disadvantages Of Operating As A Partnership 8

1.03 106 Distinguishing Partnerships From Other Relationships 17

1.04 .04 Employment Relationships Distinguished 21

1.05 107 S Corporation Comparison 23

1.06 .03 Stock Ownership Requirements 25

Test Your Knowledge 30

CHAPTER 02

Partnership Formation And Computation Of Partner Basis 37

2.01 201 Introduction 37

2.02 .04 Holding Period Of The Partner'S *Interest* And The Partnership'S Property 40

2.03 .01 Debt Transfers Treated As Payments Of Money 45

2.04 .02 Accounts Receivable 58

2.05 .08 Suspended Losses 62

2.06 .04 Contribution Of Encumbered Property 64

Test Your Knowledge 68

Final Exam Copy 76

Glossary 73

Index .....

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.

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.

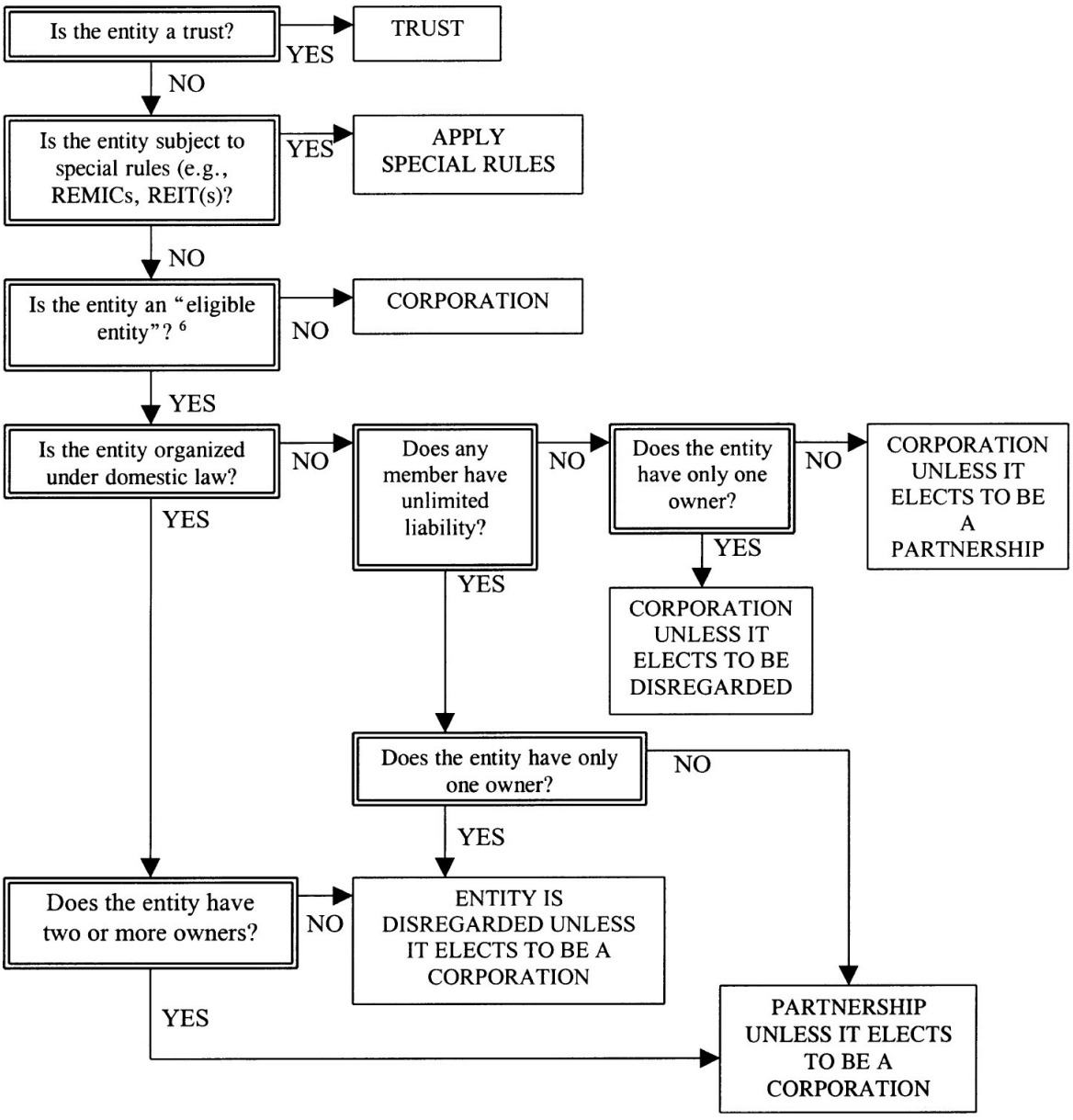
For unincorporated entities, the check-the-box regulations allow much more flexibility. While the default classification of unincorporated entities is usually to be treated as a partnership, a jointly owned, unincorporated, profit-motivated domestic business entity (such as a limited liability company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

Example 1-1

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]. A single member unincorporated entity is treated as a "disregarded entity" unless it elects to be a corporation. It cannot be treated as a partnership. For example, a single member LLC owned by an individual will be treated as a sole proprietorship unless the individual elects to be treated as a corporation. Its business income and expenses will be reported on the individual's Schedule C, Form 1040, and its rental income or loss will be reported on the individual's Schedule E, Form 1040. A corporation which owns a single member LLC would report its results as if it were a branch if it did not elect to treat the LLC as a separate corporate subsidiary.

301.7701-3 REGULATIONS (EFFECTIVE FOR ENTITIES FORMED ON OR AFTER JANUARY 1, 1997)[7]



For entities in existence prior to January 1, 1997, their previously claimed classification will generally be respected for periods prior to that date if it was reasonable under the prior rules[8].

103 ADVANTAGES AND DISADVANTAGES OF OPERATING AS A PARTNERSHIP

Flow-through taxation. Partnerships are a very popular form of business entity, especially from a tax perspective. The primary advantage of operating as a partnership for tax purposes is that although the partnership must file a tax return, a partnership itself is not taxable. Rather, the income from the partnership flows through to the partners and is reported by them in the same character as it was recognized by the partnership (as ordinary income or capital gain, for example). This can have two positive effects. First, the income of the partnership is only taxed once, at the partner level, unlike the double taxation imposed on corporate income. Second, if the partnership has a loss, partners will be able to deduct their share of the loss against their other income on their individual tax returns (subject to basis, at-risk, and passive loss limitations). In contrast, shareholders in a regular C corporation cannot deduct their shares of a corporate loss; the loss stays at the corporate level where it can only be carried forward to offset the corporation's future income. It should be noted, however, that since an S corporation is also a flow-through entity, an S corporation shareholder would be able to deduct her share of the S corporation's loss. It should also be noted again that an entity does not have to be a partnership to be taxed as one. LLCs are commonly taxed as partnerships, as are specific types of partnerships such as LLPs and LLLPs.

Example 1-2

Alejandra is a 50% partner in AJ Enterprises, LLC. For the current year, the partnership reported taxable income of $175,000 and it distributed $100,000 to the two partners ($50,000 each). Although the partnership will report the $175,000 income on its tax return, it would not pay any tax. Rather, Alejandra and her partner will each report $87,500 on their individual tax returns and will pay tax at their rates. The cash distributions will not be taxable to either partner, as they are merely distributions of income already taxed to the partners.

Note that if AJ Enterprises, LLC, were taxable as a corporation, it would owe $36,750 in corporate income tax ($175,000 × the 21% corporate tax rate). In addition, Alejandra would recognize her $50,000 distribution as dividend income (as would the other shareholder). The net result is that $275,000 would be subject to taxation—the underlying $175,000 income at the corporate tax rate and the $100,000 in dividend distributions at the shareholders' individual tax rates.

Property distributions. Another often overlooked tax advantage of operating as a partnership is that it can be much less expensive to get assets (especially appreciated non-cash assets) out of a partnership than it is to get them out of a corporation.

Generally, distributions of property from a partnership are tax-free to both the partnership and the partner, although distributions of cash can result in gain to a partner. Distributions of property from a corporation, however, are dividend income to the shareholder, but will also result in taxable gain to the corporation if the assets distributed are appreciated assets. Dividends received by individuals, like capital gains, are taxed at lower rates.

Tax-free formation. It can also be less expensive from a tax perspective to form a partnership than it is to form a corporation. The requirements of Code Sec. 351 must be met in order for the formation of a corporation (whether it is taxed as a C corporation or an S corporation) to be tax-free. This means generally that property must be contributed, stock must be received, and 80% control must be owned by the contributors after the contribution. No such requirements exist for partnerships. Contributions of property to partnerships are generally tax-free unless the net liabilities the partner is relieved of due to the contribution exceed the partner's basis in their partnership interest.

Special allocations. A partnership also has the advantage of being able to specially allocate items of income or deduction to different partners. All the depreciation on a building can be allocated to just one partner, for example. Although there are detailed rules limiting the circumstances under which this can be done and the amounts that can be specially allocated, special allocations are commonly used to make investment in a partnership more attractive to high-tax bracket partners. Shareholders in corporations, whether they are C corporations or S corporations, cannot be specially allocated items of income or deduction.

Unlimited liability. Partnerships usually have the disadvantage of not shielding the general partners from the liabilities of the partnership. This is a major disadvantage for the general partners and is one reason why so many businesses are now operated as LLCs. LLCs generally choose to be taxed as partnerships, but their owners are shielded from the liabilities of the entity.

Self-employment income. A disadvantage of being taxed as a partnership is that the general (but not limited) partners' shares of any trade or business income of the partnership is taxable to them as self-employment income, subject to both the regular income tax and the self-employment tax. Guaranteed payments for services provided by limited partners are also treated as self-employment income. Dividend distributions from a corporation are not self-employment income to the shareholders, although wages paid to the shareholders will be subject to FICA taxes.

Other advantages of the partnership form: