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Issue Contents

Bankruptcy
General
Marshalling **138**
Federal Estate and Gift Taxation
Gifts **138**
Portability **139**
Refund **139**
Special use valuation **139**
Federal Income Taxation
Business expenses **140**
Charitable deductions **140**
Disaster losses **140**
Disaster relief **140**
Health insurance **141**
Income of minors **142**
Innocent spouse relief **142**
Like-kind exchanges **142**
Job hunting expenses **142**
Partnerships
Returns **143**
Refund **143**
Sale of residence **143**

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A Complete Misinterpretation of the "Small Partnership" Exception

-by Neil E. Harl*

The "small partnership" exception, enacted in 1982 as part of TEFRA,[1] has been criticized in the past, mostly by the Joint Committee on Taxation, but never as irresponsibly as the recent release by the Office of Chief Counsel of the Internal Revenue Service, dated July 12, 2017 and released August 18, 2017.[2] The author (or authors) write as though they had never read I.R.C. § 6231(a)(1)(B) of the Internal Revenue Code. The criticism comes less than six months before the "small partnership" exception is scheduled to be history unless an aggressive effort to save the highly important concept before the end of this year is achieved with the Congress (it is pending as HR 3508).

Coming in the eleventh hour, the current criticism appears to be aimed at introducing some doubt about the provision among farmers, ranchers and other small businesses.

The heart of the controversy

The controversy dates from the late 1970s when concern about irresponsible investment, mostly in farm livestock, became prominent.

However, during the 1970s, the search for effective solutions shifted to partnerships, particularly limited partnerships as the root cause of the problem. That led to TEFRA, the 1982 major enactment which "cracked down" on partnerships. A small group of Senators and Members of the House of Representatives convened to add an amendment to ease the complexity for small taxpayers. That amendment ended up as Section 6231(a)(1)(B) of the Internal Revenue Code. That Internal Revenue Code subsection stated (and is still in effect and in good standing) –

> "The term "partnership" shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation [which was added later], or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner."

Notice carefully – The term "partnership" shall not include any partnership having 10 or fewer partners. The subsection *preceding* 6231(a)(1)(B) states – the term "partnership means any partnership required to file a return under section 6031(a) and the "small partnerships" do not have to file under section 6031. It is as simple as that. Thus, the entities coming

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within I.R.C. § 6231(a)(1)(b) *are not required to file a return as a partnership*. That is crystal clear.

Until recently, that interpretation was followed without question. A few complaints were heard, mostly coming from tax practitioners who objected to the fact that the filing was so simple that it "hurt their bottom line" because filing a tax return was made so simple many taxpayers could prepare their own return.

So why is there complaining?

The Chief Counsel Memorandum states, erroneously, that neither I.R.C. § 6031 nor I.R.C. § 6698 ". . . contain an automatic exception to the general filing requirement. That is simply not true. There is no way to read any statute to require any "general filing requirement" or any other requirement imposed on partnerships that are required by the "small partnership" exception. The two concepts are simply not linked. The "small partnerships" are separate and distinct from other partnerships that do not qualify for the "small partnership" statute. The "small partnership" was enacted to provide a simpler way to file a tax return for small partnerships.

Other guidance

Another source of helpful guidance is Rev. Proc. 84-35[3] (which is cited erroneously seven times in the Office of Chief Counsel Memorandum as Rev. Proc. 84-53 which has nothing to do with the controversy).

The Chief Counsel memorandum states that ". . . we conclude that Rev. Proc. 84-35 does not provide an automatic exemption to partnerships from the requirement of filing a Form 1065. " That statement is totally misleading. As those who have been taking advantage of the "small partnership" know, the income from the "small partnership" is simply passed directly to the taxpayer for inclusion in their Form 1040.

END NOTES

[1] The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(a), 96 Stat. 324 (1982), *enacting* I.R.C. § 6231(a)(1)(B).

[2] See Office of Chief Counsel, Internal Revenue Service Memorandum, CCA 201733013, July 12, 2017.

[3] This author was a member of a small task force convened by the Department of the Treasury and IRS in 1967 to generate ideas on how the matter should be addressed. That group produced several ideas, most of which were enacted in 1969, 1976, 1982 and 1986.

[3] 1984-1 C.B. 509.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

MARSHALLING. The debtor had originally filed for Chapter 12. A bank held a security interest in the debtor's real estate, crops and farm equipment. Another creditor had a security interest in the crops and equipment but no interest in the real estate. The second creditor sought, under the doctrine of marshalling, to require the bank to look to the real estate first so that the second creditor could recover from the other farm property. The court in the Chapter 12 bankruptcy case denied the marshalling request because the Chapter 12 plan provided that the debtor would retain the real estate in the farm operation. *In re Ferguson, 2011 Bankr. LEXIS 4581 (Bankr. C.D. Ill. 2011)*. The Chapter 12 case was later converted to Chapter 7 with all property sold. The second creditor again sought to have the marshalling request reinstated and approved. The debtor and IRS objected to the request, arguing that the funds from the sale of the crop and equipment were needed to pay the taxes resulting from the sale of the real property, crops and equipment. Note: the Bankruptcy Court had applied the holding in *Hall v. U.S., 566 U.S. 506 (2012)* during the Chapter 12 case and held that the taxes from the sale of the farm property were not dischargeable unsecured claims. The Bankruptcy Court stated that the debtor's personal liability for the taxes from the sale of the real property in the Chapter 7 case was not clear. The debtor and IRS further argued that allowing the second creditor to receive the funds from the sale of the crops and equipment would be unfair to the other creditors and debtor in reducing the funds available to pay claims. The Bankruptcy Court noted that the doctrine of marshalling was not a fairness issue but one of protecting secured claimants by ordering the payment of priority secured claims first from priority collateral so that junior lienholders could recover from other collateral. Thus, the Bankruptcy Court held that marshalling would be allowed and the second creditor paid first from the funds remaining from the sale of the crops and equipment, subject only to trustee fees. The appellate court affirmed. ***In re* Ferguson, 2017 U.S. Dist. LEXIS 140567 (C.D. Ill. 2017), *aff'g*, 2013 Bankr. LEXIS 3386 (Bankr. C.D. Ill. 2013)**.

FEDERAL ESTATE AND GIFT TAXATION

GIFTS. The decedent created a limited liability company to which the decedent contributed 12 works of art. After an appraisal of the value of the artwork was obtained, the decedent gave interests in the LLC to several nieces equal in value to the unified credit at the time plus the annual exclusion amount in late 2001 and early 2002. The purpose of the gifts was to reduce the estate tax liability for the art works. The decedent initially planned to make annual gifts of additional LLC interests to the nieces in amounts equal to the annual exclusion amount. Because the 2002 gifts of the LLC