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Issue Contents

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Repeal of the "Small Partnership" Exception: A Devious and Highly Suspicious Congressional Move

-by Neil E. Harl*

In what must rank as the most outrageous move by Congress in modern times, the Senate and House of Representatives passed and the President signed the *Bipartisan Budget Act of 2015*[1] which, understandably, focused on budget matters, but allowed those with no sense of (or respect for) the original purpose of the "small partnership" exception[2] to add a major piece of *tax* legislation in a *budget* bill killing that tax provision after 2017.[3] The provision in question, the "small partnership" exception was conceived by a group of Senators and Representatives who feared that the "get tough" legislation about to be passed in 1982, in the *Tax Equity and Fiscal Responsibility Act of 1982,*[4] would impose a heavy burden on small businesses including most farms and ranches. That move, to reduce the complexity of filing income tax returns for which 90 percent or more of the small businesses would likely be eligible, received its death notice in the 2015 Budget bill with no hearings, no prior notice that the provision was being considered for amendment or repeal *and with no good reason (in fact no reason whatsoever) for taking the action*.

Why all the fuss?

The highly complex amendments enacted otherwise in the 1982 legislation were designed to discourage tax sheltering including tax sheltering in the agricultural sector.[5] The 1982 enactments increased the complexity of partnership tax law to the point that only taxpayers with competent tax advice could master the filing of Form 1065 with the various schedules (and heavy penalties (currently $195 per partner per month for up to 12 months) and now adjusted for inflation.[6]

The "small partnership" exception for eligible taxpayers specified that the concept was available to entities with 10 or fewer members (with a husband and wife counted as one), each of whom is a natural person or estate or, after a 1997 amendment, a C corporation and each partner's share of each "partnership" was the same as each partner's share of every other item).[7] Those qualifying (and it was widely believed that more than 90 percent of the farmers and ranchers were eligible), no Form 1065 (partnership tax return) or other tax form is required to be filed at the entity level; rather, the income, losses, credits and other tax items were merely passed through to the members to report on their own Form 1040, which in most cases was to Schedules C, F or E for farm and ranch entities. No penalties were to be imposed providing the members paid the tax due at the member level.

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The "small partnership" provision specified that even entities calling themselves a partnership were not a partnership if they met the specifications for eligibility. To be a partnership, they had to *elect* to be a partnership.[8]

Who was pushing for repeal?

Judging from more than 50 years of giving seminars on the subject and more than 30 years since enactment of the legislation in 1982, it certainly was not farmers or ranchers or their organizations that were behind the repeal move.

For several years it was observed that the Internal Revenue Service, after issuing *Revenue Procedure 84-35*[9] which was reproduced word-for-word in the IRS Manual (for internal use),[10] it was clear that the Regional Service Centers and nearly all IRS agents were in denial as to the existence of the statutory authority behind the "small partnership" exception. Rather than buckle down and adapt to the concept, which was detailed in their own Internal Revenue Manual, they were mostly denying that it existed. Certainly, IRS was in a position to accept the concept, as is expected of any federal agency facing a statutory mandate, but utterly failed to do so. However, considering the standing of IRS with the Congress (and the public) in recent years, it is doubtful that the agency did the heavy lifting in lobbying for repeal.

The other culprit, as became clear over the years, was the influential organizations representing accountants as well as accounting firms and a few tax practitioners. Their concern, it became clear, was their bottom line. With a typical partnership return, the cost often ran $2,500 or more per return. A taxpayer functioning under the "small partnership" exception could almost always file their own return and, if assistance was needed, it was available on a reasonable basis. Certainly, those tax practitioners opposed to the "small partnership" exception tended to throw cold water on the concept, almost always misrepresenting the idea, as often as possible.

Lessons learned

One important lesson for any professional practicing their profession, is that decisions made and recommendations made to clients should be in the age-old tradition that those decisions should be made in the client's best interest, rather than in the practitioner's best interest.

Secondly, no matter how much pressure is exerted on the legislative bodies, it is simply not appropriate to slip an important piece of *tax* legislation into a *budget* bill to insure that it would remain hidden until passage, especially when there have been no hearings held and no discussions about the proposal. There are three Tax Committees (House Ways and Means, Senate Finance and the Joint Tax Committee). They are there for a purpose – to see that tax legislation is appropriate and represents the thinking of a majority of the House and Senate Members. Those tax committees apparently were not involved.

So what's next?

Hopefully, the Congressional leadership will re-enact the biggest step toward tax simplification in half a century – before 2018.

ENDNOTES

[1] Pub. L. No. 114-74, § 1101(a), 129 Stat. 584 (2015).

[2] I.R.C. § 6231(a)(1)(B).

[3] See Harl, "The 'Small Partnership' Exception: A Way to Escape Partnership Tax Complexities," 23 *Agric. L. Dig.* 1 (2012); Harl, "Farm and Ranch Estate (and Business) Planning-Part II," *Estate Planning,* vol. 42, no. 4, pp. 21-30 (April 2015). See generally 8 Harl, *Agricultural Law* § 60.01(1)(b)(4) (2015); Harl, *Agricultural Law Manual* § 7.03(2)(b)(x) (2015); 2 Harl, *Farm Income Tax Manual* § 6.01(3) (2016 ed.).

[4] Pub. No. 97-248, § 402(a), 96 Stat. 324 (1982) (TEFRA), enacting I.R.C. § 6231(a)).

[5] This author served on a task force formed by the Department of the Treasury in 1967 to review what was needed to be done to reduce or eliminate tax sheltering. The Washington view then was that the cash method of accounting was primarily responsible. The task force refused to recommend the elimination of cash accounting but made other recommendations which were mostly enacted in 1969, 1976, 1982 and 1986.

[6] I.R.C. § 6698(a),(b).

[7] I.R.C. § 8231(a)(1)(B).

[8] I.R.C. § 6231(a)(1)(B)(ii).

[9] Rev. Proc. 84-35, 1984-1 C.B. 509.

[10] IRM 20.1.2.3.3.1.

Letter to the Iowa Congressional Delegation

Those who would like to see the "small partnership" exception continue beyond 2017 are encouraged to communicate with their Congressional Delegation.

To: Sen. Charles Grassley; Sen. Joni Ernst; Rep. Rod Blum; Rep. David Loebsack; Rep. David Young; Rep. Steve King

Dear Senators and Representatives:

Rarely, have I been driven to correspond with our Senators and Representatives in Congress. But a recent development has made that necessary. A highly important provision, enacted in 1982 as part of the Tax Equity and Fiscal Responsibility Act of 1982 was slipped into the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, § 1101(a), 129 Stat. 584 (2015), and passed along with the rest of the Act. The provision, which has been relied upon since enactment by farmers and other small businesses is found in Section 6231(a)(1)(B) of the Internal Revenue Code and has become known as the "small partnership" exception.

First, let me say that it is highly unusual for an important tax issue to be lodged in the massive budget bill although it is probably done. Moreover, there were no hearings preceding the enactment and those of us who monitor fairly closely the various tax bills were taken totally by surprise.

But let me explain what is involved. In 1967 I was a member of a small task force appointed by the Department of the Treasury to provide ideas on how to reduce tax sheltering including tax sheltering in the agricultural sector. We provided several ideas which were mostly enacted in 1969, 1976, 1982 and 1986. During the 1970s, the Congressional Committees focused heavily on the way partnerships, principally limited partnerships, were being employed in the bulk of the tax shelters. That led to several hearings which made it clear that tougher rules would be forthcoming governing partnerships. That alarmed a small group of Senators and Representatives who, according to the committee reports, succeeded in getting drafted and included in the Tax Equity and Fiscal Responsibility Act of 1982, a provision for simplification of tax reporting for those operating as partnerships and more recently, operating as limited liability companies. As recited in Rev. Proc. 81-11, § 2.04, 1981-1 C.B. 651:

> The committee reports indicate that Congressional intent was not to impose additional filing requirements on existing small partnerships of the type that historically had not filed partnership returns, e.g., a small family farm partnership, a small, family-owned retain store, or in some cases, co-ownership of property.

The statutory provision, included in TEFRA, simply provided that, for eligible entities, income, losses, credits and other tax items would pass through to the appropriate schedule on Form 1040. Thus, there was no revenue loss for the United States Government, but it provided a very simple procedure for tax filing for the taxpayer. That provision, in Section 6231(a)(1)(B), was used in the 34 years following by hundreds and hundreds of farmers and small businesses. It was a regular item in my all-day seminars for lawyers, CPAs and accountants since 1982.

The surprise inclusion of repeal of the "small partnership" provision in the Bipartisan Budget Act of 2015, § 1101(a) was a great surprise to those of us who are involved in helping small business and farm taxpayers understand the tax law, which has grown more and more complicated. To put it even more bluntly we were shocked and dismayed. At a time when we hear talk of tax simplification, the repeal would eliminate, in my opinion, the most obvious and successful tax simplification move ever and it had been in use for 34 years with great success.

Therefore, on behalf of small taxpayers everywhere, I plead with you to do what you can to repeal the offensive provision which is scheduled to go into effect after 2017. Please accept my thanks for whatever you can do to eliminate this provision as soon as possible so that tax planning will not need to be changed to a more expensive and complicated procedure.

Sincerely yours,

Neil E. Harl

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

BANKRUPTCY

GENERAL

EXEMPTIONS.

EARNINGS. The debtor filed for Chapter 12 and identified one of the bankruptcy assets as the proceeds from the sale of crops. The proceeds were subject to the secured claims of the FSA and the debtor claimed an exemption in most of the proceeds under Minn. Stat. § 550.37(13) as exempt earnings. Another creditor and the trustee objected to the exemption; however, the creditor, trustee and the debtor stipulated an agreement which provided for a negotiated minimum portion of the claimed exempt proceeds to be paid to unsecured creditors and administration costs. The agreement also provided that, if the exemption was not allowed by the court, the full amount of the unsecured portion of the proceeds would be paid. After the agreement was reached, the checks of the proceeds were turned over to the FSA. The creditor argued that the proceeds were no longer property of the debtor and that the dispute over the exemption was moot. The appellate court held that payment of the checks to the FSA did not override the stipulated agreement nor govern the eligibility of the unsecured proceeds for the exemption. On remand to the Bankruptcy Court, the court looked at whether the proceeds of the sale of the crop were eligible for the exemption under Minn. Stat. § 550.37(13) as earnings. The Bankruptcy Court held that the proceeds of the crops were earnings to the debtor