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The “Small Partnership” Exception: A Way to Escape Partnership Tax Complexity

-by Neil E. Harl*

In 1982, Congress authorized a “small partnership” exception to the definition of “partnership” in legislation designed to tighten the rules on partnership audits.¹ Tax shelters were dominating the discussion in tax circles and the 1982 legislation was aimed at bolstering the oversight over partnership transactions, much of which was being carried on by limited partnerships. However, the small partnership exception, by its terms, provides an avenue for many small partnerships (including limited liability companies and limited liability partnerships) to sidestep the complexity of federal partnership tax law.

The bounds of the “exception”

A partnership return on Form 1065 is required even though the partnership has no taxable income.² A penalty of \$195 per partner per month is imposed on the partnership for failure to file a timely or complete Form 1065 (a maximum of 12 months’ penalty).³ This penalty is in addition to the criminal penalties for willful failure to file a return or supply information.⁴ A “partnership” is defined to include any partnership required to file a return⁵ other than those qualifying for the “small partnership” exception.⁶

In general, under the statute, a “partnership” *shall not include* a partnership if the partnership has 10 or fewer partners, each of whom is a natural person (other than a nonresident alien), a C corporation or an estate of a deceased partner.⁷ Each partner’s distributive share applies equally to every partnership item. A husband and wife are treated as one partner.⁸ A “flow through” entity cannot be a partner in a “small partnership.”⁹

Note the verb “shall” in the statutory definition. Partnerships meeting the requirements to be a “small partnership” within the exception *are ineligible to be deemed a partnership*. In fact, the very next subsection outlines an election procedure for those within the small partnership exception who want to elect *not* to have the small partnership exception apply.¹⁰ The election, once made, applies for that taxable year and all subsequent taxable years unless revoked and revocation requires the consent of the Secretary.¹¹ It is notable that no election is required to be a “small partnership” within the exception – that status *flows automatically from meeting the statutory requirements*.

The regulations¹² go on to state that if the 10-partner limit is met, it is acceptable if more than 10 partners own interests in the partnership for some portion of the taxable year.¹³

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A small partnership meeting all of the requirements is considered to have met the reasonable cause test and is not subject to the penalty for failure to file a timely or complete Form 1065 provided that all partners have reported fully their shares of income, deductions and credits from the partnership on their own timely-filed income tax return.¹⁴

As further evidence of the reasons behind the enactment in 1982, IRS in *Rev. Proc. 81-11*¹⁵ stated –

“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.”

How are partnership items reported?

So how do the “small partnerships” report their income? The statute is not clear on that point but the definition of “partner” implies that each partner is to take into account the “partnership items” which would include income, gains, losses and credits.¹⁶ Those items would be reported on Schedule C, F or E as would be appropriate for that partner.

Judicial response

To date, there have been 18 litigated cases on the “small partnership” exception. In *McKnight v. Commissioner*,¹⁷ the “small partnership” exception was upheld, the regulations were deemed valid and there was no conflict found with other pertinent regulations. In *Davis v. Commissioner*,¹⁸ the court held that no final partnership administrative adjustment was made because the partnership was excepted from partnership audit.¹⁹ The same conclusion was reached in *Harrell v. Commissioner*.²⁰

Importance of the provision

A significant proportion of all partnerships and a substantial fraction of farm and ranch partnerships appear eligible to meet the requirements to be within the “small partnership” exception. The availability of the exception generally means a lower annual cost for income tax return preparation and freedom from the onerous penalties for failure to file a timely or complete Form 1065,²¹ not to mention the advantage of sidestepping the complex rules that apply to partnerships generally such as the depreciation rules applicable to partnerships after transfer of depreciable assets to the partnership.²²

ENDNOTES

¹ The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 402(a), enacting I.R.C. § 6231(a). See generally 2 Harl, *Farm Income Tax Manual* § 6.01[2][a][i], [ii] (2011 ed.).

² I.R.C. § 6031(a).

³ I.R.C. § 6698(a), (b).

⁴ I.R.C. § 7203.

⁵ I.R.C. § 6031(a).

⁶ I.R.C. § 6231(a)(1)(B). See *Hollen v. Commissioner*, 2002-1 U.S. Tax Cas. (CCH) ¶ 50,182 (8th Cir. 2002) (income from fruit and flower farm treated as partnership distributive share even though not a partnership under state law).

⁷ I.R.C. § 6231(a)(1)(B)(i).

⁸ *Id.*

⁹ *Id.* See Rev. Rul. 2004-88, 2004-2 C.B. 165 (pass-through partners disqualified partnership from “small partnership” exception even though it was disregarded entity).

¹⁰ I.R.C. § 6231(a)(1)(B)(ii).

¹¹ *Id.*

¹² Treas. Reg. § 301.6231(a)(1)-1(a)(1).

¹³ *Id.*

¹⁴ Rev. Proc. 84-35, 1984-1 C.B. 509.

¹⁵ 1981-1 C.B. 651, § 2.04, *modified and superseded by* Rev. Proc. 1984-35, 1984-1 C.B. 509.

¹⁶ I.R.C. § 6231(a)(2)(B).

¹⁷ 93-2 U.S. Tax Cas. (CCH) ¶ 50,626 (5th Cir. 1993).

¹⁸ T.C. Memo. 1997-80, *aff'd*, 98-2 U.S. Tax Cas. (CCH) ¶ 50,600 (10th Cir. 1998).

¹⁹ *Id.*

²⁰ 91 T.C. 242 (1988).

²¹ See note 3 *supra*.

²² See Treas. Reg. § 1.704-3. See also 2 Harl, *Farm Income Tax Manual* § 6.02[1][e][i] (2011 ed.).