



The “small partnership” exception: a way to escape partnership tax complexity

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In 1982, Congress authorized a “small partnership” exception to the definition of “partnership” in legislation designed to tighten the rules on partnership audits. 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. 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). This penalty is in addition to the criminal penalties for willful failure to file a return or supply information. A partnership is defined to include any partnership required to file a return other than those qualifying for the small partnership exception.

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. Each partner’s distributive share applies equally to every partnership item. A husband and wife are treated as one partner. A “flow through” entity cannot be a partner in a small partnership.

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. The election, once made, applies for that taxable year and all subsequent taxable years unless revoked and revocation requires the consent of the Secretary. 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 regulations 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.

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.

As further evidence of the reasons behind the enactment in 1982, IRS in Rev. Proc. 81-1115 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 retail store, or, in some cases, coownership 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. Those items would be reported on Schedule C, F or E as would be appropriate for that partner.

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Judicial response

To date, there have been 18 litigated cases on the "small partnership" exception. In McKnight v. Commissioner, 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, the court held that no final partnership administrative adjustment was made because the partnership was excepted from partnership audit. The same conclusion was reached in Harrell v. Commissioner.

Importance of the provision

A significant proportion of all partnerships and a substantial fraction of farm and ranch partner-

ships 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, 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.

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Retirement planning for farm families

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Farm families face challenges related to retirement planning and implementation similar to other small businesses. This article briefly addresses two primary challenges. They are the visualization of a retirement lifestyle and confidence in funding that lifestyle.

Farmers are uniquely situated to implement subtle variations of retirement allowing for individualized alternatives. There isn't a "turning in the keys" moment. Changes in enterprises, increased use of off farm labor sources, custom operations, custom farming, crop share and cash rent leasing of land allow for a transition from 100 percent of operations and management being provided by the farm family to simple ownership of the limiting resource in agriculture – land.

Visualization

The identity of a farmer is often closely tied to their occupation. This may be due to several factors including the percentage of time devoted to operation and management of the operation, the high level of interaction between the farm business

and family activities. The length of time engaged in the business is another dominant factor for operators who were raised on a farm and became operators at a young age.

A first step in retirement planning is to visualize what retirement will be. An exercise to follow is:

- 1. Draw a sketch of your retirement fantasy without financial, geographical, health or other limitations.
2. On another sheet of paper, write the words to describe your retirement. Then write the words you do not want to use to describe your retirement.
3. Write a paragraph each for the things you want to do, be, have and contribute to in retirement. These four paragraphs can help to provide the positive expectations regarding the retirement phase of an individual's life.

To be practical, the next step is to outline the things you need to be doing now to make your future years dreams a reality. While there's mental work necessary to prepare, there's also financial groundwork to do.