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The Small Partnership 'Exception'

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In this article, McEowen discusses an exception from the penalty for failing to file a partnership return and the 1982 Tax Equity and Fiscal Responsibility Act audit procedures that could apply for many small business partnerships and farming operations.

Overview

Every partnership (defined as a joint venture or any other unincorporated organization) that conducts a business must file a return for each tax year that reports the items of gross income and allowable deductions.[1] If a partnership return is not timely filed (including extensions) or is timely filed but inadequate,[2] a monthly penalty is triggered that equals $200 multiplied by the number of partners during any part of the tax year for each month (or fraction thereof) for which the failure continues.[3] However, the penalty amount is capped at 12 months. Thus, for example, the monthly penalty for a 15-partner partnership would be $3,000 (15 x $200) capped at $36,000. Such an entity is also subject to rules enacted under the 1982 Tax Equity and Fiscal Responsibility Act. These rules established unified procedures for the IRS examination of partnerships, rather than a separate examination of each partner.[4]

An exception from the penalty for failing to file a partnership return and the TEFRA audit procedures could apply for many small business partnerships and farming operations. It is important, however, to understand the scope of the exception and what is still required of those entities even if a partnership return is not filed. Often, those entities may find that simply filing a partnership return in any event is a more practical approach.

Exception for Failure to File Partnership Return

Section 211 of Subtitle B of the Revenue Act of 1978[5] (Act) added section 6698 to the IRC, which contained a penalty for failure to file a partnership return for any partnership required to file a return under section 6031 for any tax year. The Conference Report accompanying the Act states that the "penalty for failure to file is assessed against the partnership."[6] While the Act did not create a statutory exception to the penalty, the Conference Report states that the penalty "will not be imposed if the partnership can show reasonable cause for failure to file a complete or timely return." The ability to avoid the failure to file penalty by showing reasonable cause was codified in section 6698(a)(2).

The Conference Report includes the genesis of the "small partnership exception" stating that, "Smaller partnerships (those with 10 or fewer partners) will not be subject to the penalty under this reasonable cause test so long as each partner fully reports his share of the income, deductions and credits of the partnership." The Committee Report states that the Congress did not want the IRS to penalize certain small partnerships that "traditionally" did not file a partnership return —

[1] Sections 761(a), 6031(a).

[2] Meaning that the return does not contain the information required by section 6031.

[3] Section 6698(b). This is the amount for tax years beginning in 2017. Rev. Proc. 2016-55, 2016-45 IRB 707, section 3.49.

[4] The TEFRA procedures are in sections 6221-6234 and apply to partnership tax years beginning after September 3, 1982.

[5] P.L. 95-600, 92 Stat. 2763, enacted Nov. 6, 1978.

[6] Conference Report to P.L. 95-600, at 221, section 32a.

Form 1065. The Act's creation of section 6698 and the reasonable cause test of section 6698(a)(2) was not modified by the TEFRA provisions of 1982, and became the predecessor to an IRS procedure issued in 1984.

The Act's creation of section 6698 and the reasonable cause test of section 6698(a)(2) was not modified by the TEFRA provisions of 1982. In addition, the Committee Report gave rise to Rev. Proc. 81-11,[7] which noted that partnerships with 10 or fewer partners can be exempt from the penalty for failure to file a partnership return. But, neither the Act nor the TEFRA provisions created a blanket filing exception for small partnerships. The taxpayer still bears the burden to show reasonable cause based on facts and circumstances of each situation.[8]

This penalty exception was referenced in a hearing before the Ways and Means Committee on H.R. 6300[9] in 1982. Title IV of TEFRA established comprehensive procedures for unified determinations of deficiencies and refunds attributable to partnership items, and included the exception to the general rule that partners must contest adjustments to partnership items in a unified proceeding. However, the Congress excluded from the definition of "partnership" *for purposes of the unified audit and litigation procedures* partnerships with "10 or fewer partners."[10] This meant that partners in "small" partnerships could challenge an assessment attributable to partnership items by bringing individual tax refund suits.[11]

Rev. Proc. 81-11 was updated post-TEFRA with the issuance of Rev. Proc. 84-35.[12] With Rev. Proc. 84-35, the IRS continued the exemption from the filing requirement for a small partnership for penalty purposes. Under the revenue procedure, an entity that satisfies the requirements to be a small partnership will be considered to meet the reasonable cause test and will not be subject to the penalty imposed by section 6698 for the failure to file a complete or timely partnership return. However, the revenue procedure noted that each partner of the small partnership must fully report its shares of the income, deductions, and credits of the partnership on its timely filed income tax returns.

So what is a small partnership? Under Rev. Proc. 84-35, a small partnership must satisfy six requirements[13]:

- the partnership must be a domestic partnership;
- the partnership must have 10 or fewer partners;[14]
- all partners must be natural persons (other than a nonresident alien), an estate of a deceased partner, or C corporations;[15]
- each partner's share of each partnership item must be the same as the partner's share of every other item;
- all partners must have timely filed their income tax returns; and
- all partners must establish that they reported their share of the income, deductions, and credits of the partnership on their timely filed income tax returns if the IRS requests.

Thus, if a partner has transferred the partnership interest to a revocable living trust or owns the partnership interest through a single-member limited liability company, the partnership does not qualify as a small partnership for purposes of section 6698.[16]

[7] 1981-1 C.B. 651.

[8] *See, e.g.*, SCA 200135029.

[9] *See* 97th Cong., 2d Sess. 259-260 (1982).

[10] Section 6231(a)(1)(B)(i).

[11] For a discussion of this legislative history, see *Beard v. United States*, 992 F.2d 1516 (11th Cir. 1993).

[12] 1984-1 C.B. 509.

[13] A partnership that satisfies the following requirements is deemed a small partnership and is not subject to the TEFRA audit procedures unless an election is made to have the TEFRA requirements apply.

[14] A husband and wife and their estates are treated as a single partner.

[15] When Rev. Proc. 84-35 was issued, the section 6231(a)(1)(B) definition of a small partnership did not allow C corporations as partners. The statutory definition was amended effective for tax years ending after August 5, 1997, to allow C corporations as partners. Rev. Proc. 84-35 should be read in accordance with that statutory amendment.

[16] The treatment of a grantor trust and single member LLC as disregarded entities does not apply for the determination of whether the partnership interest is held by an individual. Reg. section 301.6231(a)(1)-1(a)(2) treats a single member LLC as a passthrough partner. *See* Rev. Rul. 2004-88, 2004-2 C.B. 165.

Applying the Small Partnership Exception

So how does the small partnership exception work in practice? Typically, the IRS will have asserted the section 6698 penalty for the failure to file a partnership return. The penalty can be assessed *before* the partnership has an opportunity to assert reasonable cause or after the IRS has considered and rejected the taxpayer's claim.[17] When that happens the partnership must request reconsideration of the penalty and establish that the small partnership exception applies so that reasonable cause exists to excuse the failure to file a partnership return.[18]

The burden is on the taxpayer throughout this process. That is a key point. Usually, the partners will likely decide that it is simply easier to file a partnership return instead of potentially getting the partnership into a situation in which the partnership (and the partners) must satisfy an IRS request to establish that all partners have fully reported their shares of income, deductions, and credits on their own timely filed returns. Thus, the best approach for practitioners to follow is to simply file a partnership return to avoid the possibility that the IRS would assert the $200-per-partner-per-month penalty and issue an assessment notice. The IRS has the ability to identify the nonfiled partnership return from the tax identification number matching process. Certainly, clients do not appreciate getting an IRS assessment notice.

Even though the failure-to-file penalties can be avoided via the small partnership exception, it is still necessary that all items of income, deductions, and credit from the partnership be properly reported on a timely basis on the partners' individual tax returns. Also, the partnership allocation percentages must be the same for all partnership tax attributes. The tax preparer will have to split income and expense into two or more separate Schedules F and allocate depreciation and other tax items among the partners. In most instances, therefore, it will be much easier to simply report all this information on a partnership tax return than to do the same calculations and then attempt to allocate individual items of income and expense to each partner. Also, it is highly unlikely that a practitioner will be paid for time spent straightening out the IRS penalty assessment notice. A much better practice is to simply prepare the partnership return.

Another practitioner problem that could be encountered is that when a penalty abatement request is made based on the reasonable cause because of the small partnership exception, the IRS may take the position that relief is unavailable because the IRS has determined that the partnership seeking abatement had elected to be subject to the TEFRA audit procedures. This problem can arise if the practitioner has checked a box on the partnership return electing the TEFRA procedures for examination. That election seems to make sense — it gets the TEFRA unified audit procedures for the partnership rather than an audit of every partner's return. However, the IRS's position is that electing the TEFRA procedures (either by checking a box on the partnership return, line 5 of Form 1065, or filing Form 8893) constitutes an election *out* of the small partnership exception for purposes of the failure-to-file penalty of section 6698 and that the reasonable cause relief of Rev. Proc. 84-35 does not apply.[19] If a practitioner ends up in this situation, it may be possible to abate the penalty if there has been timely compliance for the previous three years. But if the IRS interpretation is correct, the TEFRA consolidated audit procedures should *not* be elected for small partnerships.[20]

Actual Relief of the Small Partnership Exception

Typically, the small partnership exception's usefulness is limited to situations in which the partners are unaware of the partnership return filing requirement or are unaware that they have a partnership for tax purposes, and the IRS asserts

[17] *See* SCA 200135029.

[18] The IRS has indicated that it could send a notice to a partnership that failed to file a return along with a questionnaire that could be completed and returned to the IRS so the IRS could determine whether the penalty can be excused. *See* SCA 200135029.

[19] This appears to be an unofficial IRS position. *See, e.g.*, blog post of Brian Germer, "Partnership Late Filing Penalty Update," PDXCPA (Oct. 1, 2012).

[20] For a detailed discussion of this problem and the associated arguments that the IRS position is incorrect, see J. Leigh Griffith and Jon P. Gaston, "Is the IRS Mounting a New Challenge to Small Partnership Exception to Penalty for Not Timely Filing a Complete Return Under TEFRA Rules?" 58 *Tenn. CPA J.* 26 (Sept./Oct. 2013).

the penalty for failing to file a partnership return. In those situations the partnership can use the exception to show reasonable cause for the failure to file a partnership return. But even if the exception is deemed to apply, the IRS can require that the individual partners prove that they have properly reported all tax items on their individual returns.

Also, if the small partnership exception applies, it does *not* mean that the small partnership is not a partnership for tax purposes.[21] It means only that the small partnership is not subject to the penalty for failure to file a partnership return and the TEFRA audit procedures.[22]

The small partnership exception applies only for TEFRA audit procedures and not the entire code because the statutory definition of small partnership in section 6231(a)(1)(B) applies only in the context of subchapter C of chapter 63, which is titled, "Assessment." Thus, the exception for a small partnership means only that the IRS can determine the treatment of a partnership item at the partner level, rather than being required to determine the treatment at the partnership level. The subchapter does not contain any exception from a filing requirement. By contrast, the rules for the filing of a partnership return (a partnership defined in section 761, which is in chapter 1) are found in chapter 61, subchapter A — specifically, section 6031. Because a partnership is defined in section 761 for purposes of filing a return rather than under section 6231, and the requirement to file is in section 6031, the small partnership exception has no application for purposes of filing a partnership return. Thus, Rev. Proc. 84-35 states that if specific criteria are satisfied, there is no penalty for failure to file a timely or complete partnership return. There is no blanket exception from filing a partnership return. A requirement to meet this exception includes the partner timely reporting the share of partnership income, deductions, and credits on the partner's tax return. Those amounts cannot be determined without the partnership's computing them, using accounting methods determined by the partnership and perhaps the partnership's making elections, for example, under section 179.

The small partnership exception does not apply outside TEFRA. Any suggestion otherwise is simply a misreading of the code.

Conclusion

The small partnership exception usually arises as an after-the-fact attempt at establishing reasonable cause to avoid penalties for failure to file a partnership return. The exception was enacted in 1982 as part of TEFRA to implement unified audit examination and litigation provisions that centralize treatment of partnership taxation issues and ensure equal treatment of partners by uniformly adjusting the tax liability of partners in a partnership. It is far from a way to escape partnership tax complexity, and it is not a blanket exemption from the other requirements that apply to all partnerships.[23] Failure to file a partnership return could have significant consequences for the small partnership. Ignoring subchapter K also could have profound consequences, the least of which is dealing with penalty notices.

[21] This argument was tried by the chapter 12 bankrupt debtor's expert witness in *In re Hemann*, No. 11-00261 (Bankr. N.D. Iowa 2013). (In *Hemann*, the chapter 12 debtor sold an interest in a farm partnership (which met the TEFRA definition of a small partnership) and the expert argued that, as a result, the debtor's partnership was to be treated as nonexistent with the result that the debtor's income arose from the sale of a personal interest in a farm partnership rather than a capital interest in the partnership, and qualified as the sale of a "farm asset" for purposes of 11 U.S.C. section 1222(A)(2)(a). The court rejected the expert's argument as irrelevant and stated, "the decision here will not rely in any way on his testimony." While the court noted that "there are many statements in the case law that *appear* to provide support for this assertion," there was also case law and legislative language contrary to the position of the debtor's expert (emphasis added).) Indeed, the debtor's expert cited *Miller v. United States*, 710 F. Supp. 1377 (N.D. Ga. 1989), to support the theory that a small partnership is not a partnership for all tax purposes. In *Miller*, the taxpayer argued that as a small S corporation it should be treated similar to a small partnership and that the IRS should have assessed the tax in issue directly to the taxpayer instead of via an audit of the S corporation. The S corporation shareholder claimed that the final S corporation administrative adjustment by the IRS was invalid, and therefore the shareholder was not responsible for the assessed tax because the S corporation was a small S corporation. While the court stated that the small partnership exemption applied to S corporations and thus would be "exempt from tax at the corporate level," the court was referring to the determination of a tax liability by reviewing S corporation items. That does not support the argument that the small partnership exception applies for all purposes of the code. Indeed, the *Miller* court stated that the small partnership treatment applied only for "partnership litigation procedures."

[22] *See, e.g.*, *Cahill v. Commissioner*, T.C. Memo. 2013-220.

[23] SCA 200135029.

Under the Balanced Budget Act of 2015 (BBA),[24] new partnership audit rules are instituted effective for tax returns filed for tax years beginning on or after January 1, 2018 (although a taxpayer can elect to have the BBA provisions apply to any partnership return filed after the date of enactment, November 2, 2015). The BBA contains a revised definition of a small partnership by including within the definition those partnerships that are required to furnish 100 or fewer Schedules K-1 for the year. If a partnership fits within the definition and desires to be excluded from the BBA provisions, it must make an election on a timely filed return and include the name and identification number of each partner. If the election is made, the partnership will not be subject to the BBA audit provisions and the IRS will apply the audit procedures for individual taxpayers. Thus, the partnership will be audited separately from each partner and the TEFRA rules will not apply, and the reasonable cause defense to an IRS assertion of penalties for failure to file a partnership return can be raised. It cannot be said that the BBA provisions were added in a clandestine manner to eliminate the small partnership exception to filing partnership tax returns because no such exception ever existed, through TEFRA or otherwise. ■

[24] P.L. 114-74, section 1101(a), 129 Stat. 584 (2015).