Farm Tax Network™

January 25, 2016

Small Partnerships and the Obligation to File Partnership Tax Returns

Every partnership must file a tax return for each taxable year. Small partnerships with 10 or fewer partners may be exempt from the penalty for not filing a partnership return. In this release we explain why ignoring the partnership filing requirement for small entities can be a trap.

Background

The code requires that each partnership must file a return for each taxable year [Sec. 6031(a)]. A partnership is defined to include a syndicate, group, pool, joint venture, or other unincorporated organization by means of which any business, financial operation, or venture is carried on, and which is not a corporation or a trust or estate [Sec. 761(a)]. The IRS is given the authority, at the election of all of the members of an unincorporated organization, to exclude that organization from the requirement to prepare and file a partnership return. Organizations which may elect to be excluded from the partnership rules are those formed for:

- Investment purposes only (and not for the active conduct of a business);
- The joint production, extraction, or use of property, but not for the purpose of selling services or property produced or extracted; and
- Those formed by dealers in securities for a short period for the purpose of underwriting, selling, or distributing a particular issue of securities [Sec. 761(a); Reg. 1.761-2].

The regulations provide no other exception from the requirement to prepare and file a partnership information return.

Penalty for Failure to Timely File a Partnership Return

The penalty for late filing of the partnership return is $195 per partner per month or part of a month for which the partnership information return is filed late, with the penalty capped at 12 months. The penalty is waived if the failure to file is due to reasonable cause [Sec. 6698]. Small partnerships are considered to have met the reasonable cause exception if certain tests are met [Rev. Proc. 84-35].

Small Partnership Exception to Late Filing Penalty

Domestic partnerships composed of ten or fewer partners and meeting other tests are considered “small partnerships” exempt from the late or non-filing penalty. Each partner in a small partnership must be an individual (other than a nonresident alien), a C corporation or an estate of a deceased

partner. Spouses (and their estates) are treated as one partner for the ten or fewer count [Rev. Proc. 84-35].

As an additional small partnership requirement, all items of income, deductions, and credits must be allocated in proportion to the pro-rata interests. And to qualify for the reasonable cause exception to the late filing penalty, the small partnership or any of its partners must establish that all partners have fully reported their shares of the income, deductions and credits of the partnership on their timely filed income tax returns [Rev. Proc. 84-35, sec. 3.01].

As a result of these definitions, a partnership which has a flow-through entity as a partner is not a small partnership, regardless of the size of the partnership interest owned by the flow-through entity.

Small Partnership Exception to TEFRA Unified Audit Proceedings

A small partnership, under the same definition as applies in Rev. Proc. 84-35, is not subject to the unified assessment provisions added by TEFRA in 1982 [Sec. 6221; Sec. 6231(a)(1)(B)]. The exception has no bearing on the obligation of the partnership to file a partnership information return; Sec. 6231, containing the small partnership definition, was enacted in 1982 as part of the TEFRA unified partnership examination procedures.

Small partnerships are not excluded from the requirements to file a partnership income tax return under Sec. 6031(a), as a recent U.S. District Court case informs.

The *Battle Flat* Case

A small partnership discovered that the requirement of all partners to have timely filed their tax returns is of critical importance to the automatic reasonable cause exception for partnership late filing. The government was granted summary judgment in *Battle Flat, LLC v. U.S.* [116 AFTR 2d 2015-6193, DC SD, 9/21/2015]. As it turns out, the members of Battle Flat, LLC were particularly delinquent in meeting their individual filing obligations. Six of the partners failed to timely file their personal tax returns for 2007 and three of them did not timely file Forms 1040 for 2008.

The Court stated that, although Sec. 6698 does not expressly impose a timeliness requirement on the *individual* partner tax return filings, it is exactly that type of interpretative question that is left to the discretion of the IRS in implementing the tax laws. The Court concluded that it is reasonable for the IRS to require that partners timely file their individual returns to take advantage of the small partnership exception that relieves penalties for non-filing of the partnership return.

There is no blanket exemption from the obligation for small partnerships to file a partnership tax return. In order for the partners to file their tax returns timely (i.e., within the extension period, if granted), they must know their share of the partnership income, deductions and credits. That cannot be determined unless the partnership has determined, using its accounting method, the taxable income and the other items of income, deductions and credits required to be stated separately.

Our View of the Hazards of Non-filing

Tax advisors should make every attempt to see that parties jointly conducting an ongoing business activity are properly recognizing when they are required to file as a partnership. And partnerships should make every attempt to file partnership returns timely. The failure to do so risks imposition of the $195 per partner per month penalty for late filing. Although small partnerships of 10 or fewer partners are granted a reasonable cause exception to the late filing penalty, Rev. Proc. 84-35 identifies two events outside of the partnership's control that eliminate the small partnership penalty exemption:

- Each partner must timely file and report its share of the activity's income or loss
- Each partner must be an individual, C corporation or an estate

With respect to this second definition, Rev. Proc. 84-35 directly refers to the small partnership definition in Sec. 6231(a)(1)(B), the TEFRA exception definition. This small partnership exception has been held to not apply where a partner is a disregarded entity such as a single member LLC [Rev. Rul. 2004-88] or a grantor trust [*Colin Murphy*, 129 TC 82, 2007].

Example

Sr. and Jr. Jones, father and son, farm together, with each reporting as a Schedule F proprietor. However, they conduct their "joint venture" farming activity as a single operation, using a single Jones Farm checking account for all activity. All grain production is marketed together, and all income and expenses shared equally. At tax preparation time, after compiling the various income and expense totals, each reports 50% of each item on the respective Schedule F. Several years ago, due to liability concerns, Sr. Jones had his attorney form a single member LLC to hold his share of the farming activity. Upon IRS exam and assertion of partnership status, the Sr.-Jr. farming operation would not be eligible for the small partnership exemption from the late filing penalty due to Sr.'s LLC (i.e., each owner was not an individual, C corporation or an estate).

The Section 179 Issue

The Section 179 $500,000 annual deduction limitation and an asset addition limit of $2 million apply at the partnership level [Sec. 179(d)(8)]. If two or more parties are properly conducting separate proprietorship activities but merely sharing the cost of equipment, each proprietor is entitled to the full Sec. 179 limits. But if the parties in fact are conducting a partnership activity and not reporting on Form 1065 on the premise that they are exempt as a small partnership, the IRS would reduce each owner to a proportional share of the Sec. 179 limits. Even though the IRS may not be able to impose the late filing penalty due to the 10 or fewer partners rule, the requirement of a partnership return would limit the parties to a single Sec. 179 limit.

Summary

Rev. Proc. 84-35 should be reserved for claiming a reasonable cause exception from the late filing penalty if, for whatever reason, the partnership fails to timely file. Use of the small partnership penalty exception to ignore the filing of a Form 1065 is fraught with hazard: Late filing by a partner or use of a disregarded entity by a partner negates the exception. Unfiled partnerships further risk the imposition of a single Sec. 179 limitation upon IRS examination.

Note

Recent legislation will change the due date of partnership information returns (Forms 1065) effective for tax years beginning in 2016. A calendar year 2016 partnership income tax return will be due March 15, 2017. A six-month extension will be available, making the extended due date September 15, 2017 (which is the same as under current provisions). This change was made to provide a more orderly flow for the filing of pass-through tax returns, so that the pass-through return will be due prior to the due date of the partners (individuals, trusts, calendar estates, and C corporations).

Chris Hesse and Andy Biebl