taxnotes®

Volume 152, Number 7 ■ August 15, 2016

Gross Misunderstandings of the Small Partnership Concept

By Neil E. Harl

Reprinted from *Tax Notes*, August 15, 2016, p. 1015

Gross Misunderstandings of the Small Partnership Concept

by Neil E. Harl


Neil E. Harl

Neil E. Harl is the Charles F. Curtiss Distinguished Professor in Agriculture and Life Sciences and Emeritus Professor of Economics at Iowa State University. He is also a member of the Iowa Bar.

In this article, Harl argues that Congress's recent and unexpected repeal of the small partnership exception should not be allowed to stand.

The repeal of the small partnership exception[1] through the Bipartisan Budget Act of 2015[2] came as a great shock to farmers, ranchers, and other small business persons who had made use of the exception over the past 34 years. The repeal was pulled off without a hearing, without notice that repeal was being considered, and without the repeal being included in tax legislation. Rather, it was added at the last minute, toward the back of the bulky budget bill, where it was less likely to be noticed.

In discussing the chances for reversing the repeal, it became clear that the small partnership exception was unknown to many and a mystery to others, even though the provision was in the 1982 Tax Equity and Fiscal Responsibility Act,[3] which, as is well known, was widely reviewed and often quoted around the time it was enacted. It is worthwhile to recall why the small partnership exception was established.

A. A Brief History of Tax Sheltering

Beginning in the 1960s, concern was voiced over so-called tax sheltering, especially in the agricultural sector. Investors were acquiring ownership (although not always accompanied by actual possession) of cattle primarily and at high prices. With artful use of fast depreciation, the investment credit (when it was available), and other tax deductions, investors were garnering profits, some in astonishing amounts. In 1967 I was asked to serve on a small task force organized by Treasury (with the IRS) to recommend ways to curb the practices being used.

It soon became clear that the IRS in particular believed that the villain was the cash method of accounting and wanted our task force to recommend that the practice be ended. Our group responded that it was not at all clear eliminating cash accounting would curb the tax sheltering practices and that since Treasury and the IRS had allowed cash accounting for almost a half-century and had approved the practice initially, they could end it if they chose. The response was that the agencies were reluctant to take on that battle. Our task force formulated several changes in federal law, many of which were enacted in 1969, 1976, 1982, and 1986.

In the years following 1967, the congressional committees, Treasury, and the IRS began to focus on laws governing partnerships — initially limited partnerships — as a major factor in tax sheltering. The resulting new legislation represented a "get tough" policy with partnerships as the principal target. A group of senators and House members, while agreeing that something needed to be done, became concerned about the complexity under consideration and proposed an amendment creating what is now referred to as the small partnership exception for eligible entities.

B. Simplicity of Small Partnership Exception

The brief provision, which became part of TEFRA, was lodged not in subchapter K but toward the back of the code, occupying a part of an existing code section. It says that if an entity has 10 or fewer members (a husband and wife are treated as one member) and the members are individuals or the estates of individuals (C corporations were added by amendment in 1997[4]), the entity is eligible to use the small partnership exception. The statute states:

> *The term "partnership" shall not include any partnership* having 10 or fewer partners each of

[1]Section 6231(a)(1)(B).
[2]P.L. 114-74, section 1101(a).
[3]P.L. 97-248, section 402(a) (adding section 6231(a)(1)(B)).
[4]Taxpayer Relief Act of 1997, P.L. 105-34, section 1234(a) (amending section 6231(a)(1)(B)(i)).

whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner. [Emphasis added.]

As explained below, that passage distances small partnerships from the onerous penalty rules and other requirements applicable to partnerships generally. No election is required by an entity to become a small partnership.[5] However, an election is necessary if an entity eligible for the small partnership exception wishes to be treated as a partnership.[6] The statutory passage intentionally creates a stand-alone provision in the interest of tax simplification for eligible taxpayers.

Small partnerships are not subject to penalties for failing to file a tax return,[7] so almost all filers include their income, losses, credits, and other tax items on the appropriate schedule on Form 1040 — Schedule C for eligible non-farm businesses, Schedule F for farmers and ranchers, and Schedule E for those inactive enough not to be subject to self-employment tax. Note that the federal revenue stream is unaffected because the income tax is paid by the members of the small partnership at the same rate and in the same amount as would be paid if it were a partnership.

C. Support in the House and Senate

The House and Senate conference reports discussed the small partnership exception with the following identical language:

> Generally, partnerships covered by the rules include any partnership . . . required to file a return under section 6031(a).
>
> However, the rules do not apply to partnerships consisting of 10 or fewer partners each of whom is a natural person (other than a nonresident alien) or an estate, provided that each partner's share of any partnership item is the same as his distributive share of every other partnership item. A husband and wife (and their estates) shall be treated as one partner for purposes of this exception.[8]

D. The JCT's Reaction in 2016

Drawing on advice from various quarters, knowing that Congress has relatively few members who claim to be tax experts, and relying on belief gained from several years of watching how tax matters are handled in Washington, a group of us, through a congressional office, established a relationship with one of the committees providing advice to the House and Senate on tax issues.[9] Our push to reverse the repeal of the small partnership exception (scheduled to disappear after December 31, 2017) was routed to the Joint Committee on Taxation. Here are some of the many areas of discussion, much to my surprise.

1. The small partnership exception does not exist. Although I'd heard similar statements over the years in the course of my all-day seminars for attorneys and CPAs, I really did not expect to be confronted with that statement by the JCT, which is presumably knowledgeable about existing tax law. Patiently, we cited the statutory basis for the provision, the supporting regulatory material, the number of cases litigated over the 34-year period, and the use made of the exception by taxpayers — all of which respected the small partnership concept. The response was a curt denial.

More than 20 cases involving various issues with the small partnership exception, many concerning eligibility, have been litigated.[10] If there were no such thing, as the JCT repeatedly asserted, surely the lawyers representing clients in those cases would have raised the issue, or the lawyers representing the IRS would have blown the whistle. Not one of the cases raised the question whether there really is a small partnership provision.

The small partnership exception does exist, and it has for 34 years. The IRS signaled its validity in reproducing Rev. Proc. 1984-35 word for word in the Internal Revenue Manual.[11] Also, chief counsel advice as recently as 2012 stated that a tenancy by the entirety does not preclude the small partnership exception.[12] And the concept is discussed in the January 2016 version of IRS Publication 541, *Partnerships*, at page 13, which even recites the content of the small partnership exception. Yet the JCT refused to budge. Finally, it became clear that the resistance was based not so much on continuing ignorance as on some deep-seated antagonism toward a concept that collided with what the committee had been peddling for years.

2. Every partnership is subject to section 6698 penalties for failing to file a return. This argument could easily be countered by pointing out that section 6698(a) refers to the penalty provision by stating that it applies to "any *partnership* required to

[5]Section 6231(a)(1)(B)(i).
[6]Section 6231(a)(1)(B)(ii).
[7]Rev. Proc. 1984-35, 1984-1 C.B. 509.
[8]H.R. Rep. No. 97-760, at 608-609 (Aug. 17, 1982) (Conf. Rep.); and S. Rep. No. 97-530, at 608-609 (Aug. 17, 1982) (Conf. Rep.). Note the identical pagination.
[9]The House Ways and Means Committee, the Senate Finance Committee, and the JCT are the three advisory groups.
[10]*E.g.*, *Brown v. Commissioner*, T.C. Memo. 1997-548 (entity qualified as a small partnership).
[11]IRM section 20.1.2.3.3.1.
[12]ECC 201251017.

file a return'' (emphasis added). As noted above, a small partnership by statute is not a partnership. That is noted and supported in Rev. Proc. 1984-35. There is no penalty for failure to file Form 1065. Small partnerships are not subject to the heavy penalties authorized by section 6698.[13]

The lengthy discussion produced absolutely no basis to resist reenactment of the small partnership provision, which was so abruptly, baselessly, and clandestinely repealed in 2015. That should have been obvious.

E. Maintain Rare Example of 'Tax Simplification'

Cries for tax simplification are heard each year, but rarely does it happen. In fact, the small partnership exception is one of the most visible recent efforts at tax simplification. And it has worked well for 34 years. I believe this one highly visible example of simplification should not be shelved like last year's calendar.

Readers interested in tax simplification for small businesses are encouraged to let their House members and senators know that the small partnership repeal should be reversed and that the provision should be returned to the tax code. To allow the repeal confirms the acceptance of a congressional action involving taxes that was taken without hearings, notices, or warnings, and was slipped into a massive budget bill when no one was looking. That is not how we expect legislative decisions to be made. It is a shameful move that should not be allowed to stand. Moreover, the small partnership exception has worked well, and there is no reason whatsoever for the concept to be repealed. ■

[13]I was contacted in 2016 by a taxpayer with several small partnerships who had recently received a notice of more than $30,000 in penalties. The taxpayer was unaware of the small partnership exception, which would have prevented the levy of penalties.

IN THE WORKS

A look ahead to planned commentary and analysis.

Target stock basis after a double dummy: Section 351 vs. section 368 (*Tax Notes*)

Stephen Cohen asks whether section 351 offers the extra advantage of a bump in basis not available under section 368 to corporate mergers that use the so-called horizontal double-dummy transaction.

The negative capital account maze (*Tax Notes*)

Walter Schwidetzky discusses how partners' negative capital accounts affect partnership taxation, calling attention to the issues raised from the disconnect between limited liability company law and the relevant partnership law.

***Hamilton* and taxes! (*State Tax Notes*)**

Influenced by the musical *Hamilton*, Lynn Gandhi helps us remember the past to prepare for the future with a discussion on the importance of international, federal, state, and local taxation to the early economic growth and public policy of the United States.

Income tax nexus in the new economy: Third-party service providers (*State Tax Notes*)

Mike Porter et al. consider the state income tax nexus implications of the shift toward the remote delivery of goods and services as states more aggressively assert jurisdiction to tax.

A price-based royalty tax? (*Tax Notes International*)

Kimberly A. Clausing and Michael C. Durst consider the merits of a price-based royalty whose rate varies with product price as a fiscal instrument for taxing extractive industries.

Are the final BEPS reports on actions 8-10 effective now? (*Tax Notes International*)

Jason Osborn, Brian Kittle, and Kenneth Klein discuss the impact of the final base erosion and profit-shifting actions 8-10 reports, which contain final, currently applicable revisions to the OECD transfer pricing guidelines.