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Where Would the “Small Partnership” Exception Be Advantageous?

-by Neil E. Harl*

The “small partnership” exception,¹ which is found in an obscure part of the Internal Revenue Code and not in Subchapter K of the Code where most partnership provisions are located (and which has been around for 30 years)² offers a way to reduce the complexity of partnership income tax filing (and penalties) for eligible partnerships. However, there are several other provisions in tax law that can be sidestepped by taxpayers making use of the “small partnership” exception.³

What is required for the “small partnership” exception to be available?

The “small partnership” exception is, to put it bluntly, a provision that states that an entity meeting the requirements is not a partnership.⁴ That means an entity with 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,” is simply not to be treated as a partnership under federal tax law.⁵ No election is required; interestingly enough, the Internal Revenue Code specifies that an entity not wanting to be treated as under the “small partnership” exception can elect not to have the “small partnership” provisions apply to the entity.⁶

A domestic “partnership” composed of 10 or fewer “partners” and coming within the requirements of the “small partnership” exception⁷ is considered to have met the reasonable cause test and is not subject to the penalty imposed by I.R.C. § 6698 for failure to file a complete and timely partnership return provided that all partners have fully reported their shares of income, deductions and credits from the “partnership” on their own timely filed returns.⁸ An error or omission resulting in a “material understatement” of the net amount payable can result in a penalty being imposed.⁹

What about LLCs?

The regulations¹⁰ issued under the governing statute¹¹ specifically define an LLC and state –

“So long for purposes of this section, LLC means an organization – (1) formed under a law that allows the limitation of liability of all members for the organization’s debts and other obligations within the meaning of § 301.7701-3(b)(2)(ii); and (2) [is] classified as a partnership for Federal tax purposes.”

That language seems to make the provisions of the “small partnership” exception applicable to limited liability companies (which are basically partnerships for tax purposes) if the requirements are otherwise met.¹²

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Like-kind exchanges

As has been the case for many years, “interests in a partnership” have not been eligible for like-kind exchange treatment. That does not mean partnership property is not eligible for like-kind exchange treatment, only that partnership interests cannot be exchanged in a like-kind exchange.

In a 1997 private letter ruling, a co-ownership of rental properties in which partnership returns (Form 1065) had been filed as a matter of convenience for the past five years was declared ineligible for like-kind exchange treatment. That resulted in an uproar among taxpayers and resulted ultimately in the issuance of a Revenue Procedure which addressed the circumstances under which an advance ruling would be issued in situations involving co-ownership of rental real property in an arrangement classified under local law as a tenancy-in-common. The Revenue Procedure specifies conditions (15 factors) that must be met for an advance ruling.

Requirements for the two provisions for electing out of partnership status— I.R.C. § 761(a), which requires that the partnership be passive in nature and not for the conduct of an active business, and I.R.C. § 761(f), which states that husband and wife arrangements as a “joint venture” are eligible for electing out of partnership status only if both spouses are materially participating in a trade or business—do not offer helpful alternatives for taxpayers facing a possible challenge to a like-kind exchange involving partnership property.

Entities qualifying for the “small partnership” exception, not being partnerships, would seem to be able to sidestep the controversy.

Expense method depreciation

The rules for expense method depreciation contain additional limitations if a partnership is involved. The amount eligible to be expensed is limited to the taxable income derived from an active trade or business or all trades or businesses. The taxable income limitation applies at the partnership level as well as at the partner level. Also, a partner who is allocated expense method depreciation from a partnership must reduce the basis of the partner’s partnership interest by the full amount of the allocation even though the partner may not be able to deduct that year the allocated expense method depreciation.

The outcome could be different for those subject to the “small partnership” exception.

Self-employment tax liability

Although the issue is shaped by 1997 proposed regulations that have not become final, in general one’s net earnings from self-employment include the individual’s distributive share (whether or not distributed) of income or loss from any trade or business carried on by a pass-through entity. Under the “small partnership” exception, the entity is ignored and each individual reports that person’s self-employment income directly on Schedule F or C (if materially participating) or Schedule E if not materially participating with those determinations apparently made at the individual level.

Effect of death

At the death of a partner in a partnership, a major concern is assuring that the new income tax basis at death is reflected in an adjustment in basis for the partnership property. If the estate of a partner continues as a partner, the advantage of the new basis at death can be obtained through an election to increase the basis for the estate under I.R.C. § 754. If the new partner elects, an election could be filed under I.R.C. § 732(d) which assures a new basis for property distributed within two years of when the partnership interest was acquired.

With the “small partnership” exception, it appears that the new basis at death is obtained automatically by the “partners” with no elections required and with less complexity.

Holdner type problem

In cases such as Holdner v. Commissioner, the small partnership exception could possibly be helpful. In that case, the individuals involved (a father and a son, running a farming operation) did not file a partnership return, Form 1065, but IRS determined that the arrangement was a partnership nonetheless. The outcome could have been different had the taxpayers relied on the “small partnership” exception.

In conclusion

The advantages of the “small partnership” exception appear to be widespread and generally resemble the simplicity of how co-ownership arrangements have been handled. One word of caution – as one Service Center has advised, if using the “small partnership” exception, do not file a Form 1065 but be prepared to show that the income, losses, credits and other tax items have been duly reported on the appropriate schedule of each individual’s Form 1040.

ENDNOTES

6 Id.
11 Treas. Reg. § 301.6231(a)(7)-2(b)(1).
14 I.R.C. § 1031(a)(2)(D).
16 I.R.C. § 179(d)(8). See Hayden v. Comm’r, 112 T.C. 115 (1999), aff’d, 204 F.3d 772 (7th Cir. 2000) (no taxable income at partnership level so no passthrough to partners).
18 Prop. Treas. Reg. § 1.1402(a)-2(b).
20 T.C. Memo. 2010-175, aff’d, 12-2 U.S. Tax Cas. (CCH) ¶ 50,626 (9th Cir. 2012).