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The “Small Partnership” Exception: The Best Tax Simplification in a Half Century Is In Jeopardy

-by Neil E. Harl

In an unbelievably sneaky fashion, a group of unhappy tax practitioners in late 2015 managed to pull enough strings to repeal, effective after 2017, a 34-year old statute that resulted from the “tax shelter” efforts of the 1970s.¹ The statute was buried in a well camouflaged fashion in the Bipartisan Budget Act of 2015,² and passed with no debate, no hearings and no notice that a key tax provision for many farm and ranch businesses was in grave danger. The statute has provided a much simpler way to file income tax returns without filing a Form 1065 and without enduring the huge penalties that often accompany a slightly incomplete Form 1065.

The drive to reinstate the “small partnership” exception was commenced in an article, in Agricultural Law Digest, in March of 2016.³ Through the Herculean efforts of Warren Clark, who runs a promotional firm on the West Coast, a news release was sent to every daily and weekly newspaper in the United States and all agricultural publications.

The next step

The next step was to approach Congress with a plea to reinstate the brief but highly important provision. Because of earlier contacts over a period of many years, that approach was through Senator Charles Grassley of Iowa who indicated, initially, that he would be interested in supporting the reinstatement. However, he stated that he wanted to “run it by” the Joint Committee on Taxation, which was standard practice. The first of several teleconferences was held on April 6, 2016, with the initial response from a JCT staff member that “there is no such thing as the ‘small partnership’ exception” which was not countered by other staff members. At the end of the hour long session the same individual as had made the initial statement shouted into the microphone, “[I told you] there is no such thing as a ‘small partnership’ exception.” From that point forward, Senator Grassley faded into the woodwork.

Proving there was a “small partnership” exception

The efforts shifted to producing evidence that there was indeed a “small partnership” exception and that evidence would (and did) leave no doubt whatsoever, at least for those capable of reading the Internal Revenue Code and if, they were not capable of reading the Internal Revenue Code, there was ample evidence in addition to the Code.
The Internal Revenue Code language. As noted above, the statutory language states as follows in I.R.C. § 6231(a)(1)(B) – “(B) Exception for Small Partnerships — (i) In general.—The term “partnership” shall not include any partnership having 10 or fewer partners each of whom is an individual (other than a nonresident alien) a C corporation or an estate of a deceased partner. For purposes of the preceding sentence, a husband and wife (and their estates) shall be treated as 1 partner. 

“(ii) Election to have subchapter apply.— A partnership (within the meaning of subparagraph (A)) may for any taxable year elect to have clause (i) not apply. Such election shall for such taxable year and all subsequent taxable years unless revoked with the consent of the Secretary.”

Anyone who can read the English language should be able to master that clearly stated subsection.

Article in Tax Notes. In the August 15, 2016 issue of Tax Notes, a highly respected tax publication, the article noted the compelling evidence that tax counsel, taxpayers, the Internal Revenue Service and about everyone except for the staff of the Joint Committee on Taxation knew about the concept and were somehow involved in making use of the concept. As stated in the article, “[F]inally, it became clear that the resistance (on the part of JCT) was based not so much on continuing ignorance as on some deep-seated antagonism toward a concept that collided with what the committee [JCT] had been peddling for years.”

The Internal Revenue Service had demonstrated its awareness of the concept by publishing the January 2016 edition of IRS Publication 541, Partnerships, at Page 13, which details the opportunities to make use of the “small partnership” exception and by reproducing Revenue Procedure 84-35 in the Internal Revenue Manual for use by IRS agents nationwide. Also, more than 20 court cases have been litigated dealing with various aspects of the “small partnership,” mainly who would be eligible to use the concept.

To sum up

It would be a shame to lose the most important example of tax simplification in the past 50 years, which does not reduce revenue for the United States Treasury, just to placate a small group of tax practitioners who worry about their bottom line. It is well known that, with the “small partnership” exception, most taxpayers can file their own federal tax return (Form 1040) with the income, losses and credits passed through to the appropriate schedule of Form 1040 with no Form 1065 needing to be filed, thus escaping the penalties often levied on Form 1065 filers for incomplete or incorrect entries on the form.

It recalls the adage that professionals should focus on what is in their client’s best interests, not on what is in the professional’s best interests.

To save the “small partnership” exception, as is eminently justified, it is imperative that every member of Congress become familiar with the concept and that the importance of the provision to most small farmers and ranchers as well as others running small businesses become more widely (and favorably) known. It is not limited to farm and ranch taxpayers.

ENDNOTES

1. The statute is nine lines in the Internal Revenue Code and is located in I.R.C. § 6231(a)(1)(B).
4. A 1997 amendment allowed C corporations to be eligible members.
7. IRM 20.1.2.3.3.1.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

**ANIMALS**

**HORSES.** The plaintiff was injured when the plaintiff’s vehicle struck a horse owned by one of the defendants. The horse had escaped from a farm owned by the other defendants. The plaintiff sued in common-law negligence and strict liability and the horse owner sought and obtained summary judgment in the trial court. The evidence demonstrated that the horse was under the control and care of the stable owners at the time of the accident and the horse owner had last visited the farm four days before the accident. On appeal, the appellate court stated that negligence required some action by the defendant that resulted in the horse being on the highway. Because the horse was under the exclusive control of the farm owners, no negligence could be attributed to the horse owner defendant. In addition, the doctrine of res ipsa liquitor did not apply because the farm owners had exclusive control over the horse at the time of the accident. The court also upheld the grant of summary judgment on the claim of strict liability because there was no evidence that the horse owner had any knowledge of the horse’s propensity to escape or otherwise be vicious. The court noted that there was no evidence of prior escapes or that the horse had ever attempted to break out of its stall. O’Hara v. Holiday Farm, 2017 N.Y. App. Div. LEXIS 767 (N.Y. App. Div. 2017).