



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE
SIGNIFICANT SERVICE CENTER ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, BOSTON
SMALL BUSINESS/SELF EMPLOYED CC:SB:1:BOS

FROM: Assistant Chief Counsel
Administrative Provisions and Judicial Practice CC:PA:APJP

SUBJECT: I.R.C. § 6698 and Small Partnerships

This memorandum responds to your request for Significant Service Center Advice, dated May 3, 2001, in connection with an issue raised by the Taxpayer Advocate at the Andover Service Center. In accordance with I.R.C. § 6110(k)(3), this document is not to be cited as precedent.

ISSUE:

Can the Service change its administrative procedures to alleviate the impact of section 6698 of the Code upon small partnerships?

CONCLUSION:

Yes, the Service may change its administrative procedures to alleviate the impact of section 6698 upon small partnerships.

BACKGROUND:

According to your memorandum, the Taxpayer Advocate at the Andover Service Center received an inquiry from the Pacific-Northwest Citizen Advocacy Panel ("Panel") regarding the imposition of the section 6698 failure to file penalty against small partnerships as defined in section 6231(a)(1)(B) of the Internal Revenue Code and revenue procedure 84-35. Specifically, the Panel believes that small partnerships are assessed the penalty unfairly and contrary to the Congressional intent to treat small partnerships more leniently than large partnerships. The Panel also believes such partnerships are not receiving adequate information regarding relief from the penalty. Finally, the Panel believes that requiring small partnerships to request abatement of the

penalty after the penalty has been assessed by the Service imposes an unfair burden upon small partnerships.

The Panel suggests that the Service amend its procedures to include a letter to be mailed to the partnership along with the notice and demand for payment of the section 6698 penalty, informing the partnership that it may qualify for abatement of the penalty if it meets certain criteria. Specifically, the proposed letter would provide as follows:

If this partnership meets the following requirements it qualifies for a penalty abatement.

1. Is this a domestic partnership?
2. Are there 10 or fewer partners?
3. Are all partners a natural person (other than a nonresident alien) or an estate?
4. Is each partner's share of each partnership item the same as his share of every other item (a husband and wife and their estate shall be treated as one partner)?¹
5. Have all the partners fully reported their share of the income, deductions and credits of the partnership on their timely filed income tax returns?

If the answers to all of the above questions are "Yes," please sign this form and return it with a copy of the penalty assessment. You do not owe the penalty.

This letter may be required to be signed by all of the partners.

LAW & ANALYSIS:

Before we discuss the relevant statutory and administrative provisions, we feel compelled to note that the Pacific-Northwest Citizen Advocacy Panel misinterprets the scope and purpose of section 6231(a)(1)(B). Section 6231(a)(1)(B) was enacted as part of the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, Pub. L. 97-248, in an effort to provide unified partnership audit and litigation procedures. See generally I.R.C. § 6221 through 6233. These provisions, which can be found in Subchapter C of Chapter 63 (governing tax treatment of partnership items) are completely unrelated and have no bearing on the application and scope of section 6698. Likewise, the exemption of small partnerships from the unified TEFRA partnership procedures should not be read as a blanket exemption from the section 6031 filing requirement or any other statutory or regulatory requirement placed upon all partnerships. Having said

¹ We believe that the Citizen Advocacy Panel mistakenly placed the parenthetical in this question. The parenthetical relates to question 2, which deals with the number of partners in the partnership, rather than question 4.

this, we now turn to the discussion of the applicable statutory and administrative provisions.

Section 6031 of the Code requires every partnership (as defined in section 761(a)) to file a return for each taxable year. I.R.C. § 6031(a). The return must include all items of gross income and deductions allowable under subtitle A. In addition, the return must provide the names of all the partners and their distributive share of partnership income. Partnerships that fail to timely file a complete partnership return as required by section 6031(a) are subject to a penalty under section 6698, unless the failure to comply with the section 6031(a) is due to reasonable cause. See generally I.R.C. § 6698.

The section 6698 penalty is imposed for each month, or fraction thereof, during which the failure to comply with section 6031(a) continues, but not to exceed five months. I.R.C. § 6698(a). The penalty is computed at a rate of \$50 multiplied by the total number of partners in the partnership during any part of the tax year for which the return was due. I.R.C. § 6698(b). The penalty is assessed directly against the partnership. I.R.C. § 6698(c).² It may be imposed in addition to the criminal penalties under section 7203. I.R.C. § 6698(a). Deficiency procedures do not apply. I.R.C. § 6698(d).

Neither section 6031 nor section 6698 contain an exception to the general filing requirement set forth in section 6031(a). As noted above, however, the section 6698 penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause. I.R.C. § 6698(a). In relevant part, the legislative history of section 6698 provides as follows:

The penalty will not be imposed if the partnership can show that failure to file a complete or timely return is due to reasonable cause. The Committee understands that small partnerships (those with 10 or fewer partners) often do not file partnership returns, but rather each partner files a detailed statement of his share of partnership income and deductions with his own return. Although these partnerships may technically be required to file partnership returns, the Committee believes that full reporting of the partnership income and deductions by each partner is adequate and that it is reasonable not to file a partnership return in this instance.

See H. Rep. No. 95-1445, 95th Cong., 2d Sess., at 249 (1978).

² Although the penalty is assessed against the partnership, partners are individually liable for the penalty to the extent of their liability for the partnership debts generally.

With the Congressional intent in mind, the Service published guidance in the form of a revenue procedure containing criteria under which partnerships with 10 or fewer partners will not be subject to the penalty under section 6698. See Rev. Proc. 84-35, 1984-1 CB 509, *superseding* Rev. Proc. 81-11, 1981-1 CB 651. In relevant part, the revenue procedure provides as follows:

A domestic partnership composed of 10 or fewer partners and coming within the exception outlined in section 6321(a)(1)(B) of the Code will be considered to have met 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, provided that the partnership, or any of the partners, establishes, if so required by the Internal Revenue Service, 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 § 3.01.

At the time revenue procedure 84-35 was promulgated, section 6321(a)(1)(B) provided that the term “partnership,” as used in Subchapter C of Chapter 63, shall not include any domestic partnership having 10 or fewer partners each of whom is a natural person (other than a nonresident alien) or an estate, and each partner’s share of each partnership item is the same as his share of every other item.³ See also Rev. Proc. 84-35 § 2.03. Partnerships having a trust or corporation as a partner, tier partnerships, and partnerships where each partner’s interest in the capital and profits are not owned in the same proportion, or where all items or income, deductions, and credits are not allocated in proportion to the pro rata interest, do not come within the exception of section 6231(a)(1)(B) and, as such, are also not covered by Rev. Proc. 84-35. *Id.*, § 3.02. Finally, the revenue procedure provides that “[a]lthough a partnership of 10 or fewer partners may not be automatically excepted from the penalty imposed by section 6698 ... under section 3.01 [of the revenue procedure], the partnership may show other reasonable cause for failure to file a complete or timely partnership return. *Id.*, § 3.03.

Penalties exist to encourage voluntary compliance by supporting the standards of behavior expected under the Internal Revenue Code. To achieve this desired effect penalties must be proportionate to the offense they intend to correct, severe enough to deter noncompliance, and applied by the Service in a consistent, accurate, and impartial manner. See generally Penalty Policy Statement P-1-18; IRM 120.1.1.2. In addition, the taxpayers against whom the penalty is imposed must be given an opportunity to have their interest heard and considered.

³ Section I.R.C. § 6231(a)(1)(B)(i) has since been amended to include a corporate partner. See Taxpayer Relief Act of 1997, Pub. L. 105-34, § 1234(a).

While revenue procedure 84-35 does not exempt every small partnership from the application of section 6698, it sets forth criteria under which the Service will agree that a small partnership meets the reasonable cause test of section 6698. Rev. Proc. 84-35 § 3.01. Under these criteria, the Service may presume that all partners have fully reported their shares of the income, deductions, and credits of the partnership on their timely filed income tax returns. Alternatively, the Service may require the partners or the partnership to establish that the partners have in fact fully complied with their filing requirement. Id.

Generally, when a partnership fails to file a partnership return as required by section 6031(a), the partnership is subject to the section 6698 penalty. See IRM 120.1.2.8. The penalty can be assessed either automatically or manually when the partnership fails to timely file a complete Form 1065 or when a substitute for return is prepared by the Service and reasonable cause is not established. IRM 120.1.2.8.3. The penalty may be assessed before the partnership has an opportunity to assert reasonable cause or after the Service has considered and rejected the taxpayer's claim. In either case, the Service will generally reconsider the penalty either upon the taxpayer's request or when the delinquent return is filed or selected for examination. See generally IRM 120.1.1.3, *Relief from Penalties*; also IRM 120.1.2.8.3. In addition, if a delinquently filed partnership return indicates that the partnership meets the small partnership criteria set forth in revenue procedure 84-35, the penalty is automatically suppressed and/or abated. See IRM 3.11.15.14 (January 1, 2001).

The Citizen Advocacy Panel suggests that the Service uses the penalty as a "scare tactic" against small partnerships. We are not sure what this means. If the Panel is suggesting that the Service assesses the penalty against small partnerships contrary to the Congressional intent and Rev. Proc. 84-35, this assertion is not true. If, on the other hand, the Panel believes that the Service sometimes asserts the penalty against a small partnership before it is clear whether the partnership meets the criteria set forth in the revenue procedure or prior to the examination of the partners' returns, this belief is true. Requiring the Service to audit each and every partnership to determine whether it meets the criteria set forth in revenue procedure 84-35 before asserting the section 6698 penalty would not only be contrary to the Code, but also unnecessarily expensive and time consuming.

Generally, the Service does not know whether the partnership meets the reasonable cause criteria or qualifies for relief under Rev. Proc. 84-35 unless and until the partnership files a return (Form 1065) or some other document with the Service. The individual partners' income tax returns, even if timely filed and complete, are not linked together during their initial processing. Thus, the Service generally does not know how many partners are in the partnership or whether all of the partners timely filed their income tax returns unless and until the partnership (or one of its partners) is selected for an audit. Similarly, the determination of reasonable cause must generally be made

on a case-by-case basis, taking all of the relevant fact and circumstances into consideration. See IRM 120.1.1.3.1. The burden of meeting the standard falls on the taxpayer. IRM 120.1.1.3.4. While revenue procedure 84-35 creates a presumption that certain small partnerships who meet the criteria set forth in the revenue procedure also meet the reasonable cause standard of section 6698, it is the taxpayer's right and responsibility to claim that they fall within the criteria of the revenue procedure.

Having said this, however, the Service may choose to implement additional procedures to alleviate the impact of section 6698 on small partnerships. A letter or a notice similar to the one proposed by the Panel may be appropriate if, as the Panel suggests, a majority of partnerships that fail to timely file the partnership return meet the criteria set forth in Rev. Proc. 84-35. We suggest that the document explain the statutory requirement and the reason for the penalty. We also recommend that the notice require all partners to include their full name and Taxpayer Identification Number (TIN) and that it be signed by each partner under the penalties of perjury.

The notice may provide something akin to the following:

You have failed to timely file a complete partnership return as required by section 6031(a) of the Internal Revenue Code. The law allows us to assess a penalty against you. The penalty is imposed for each month, or fraction of the month, during which the failure to comply with section 6031(a) continues, but will not exceed five months. The amount of the penalty is computed at a rate of \$50 multiplied by the total number of partners in the partnership during any part of the tax year for which the return was due.

The law allows us to abate the penalty if the failure to file was based on reasonable cause. To request a penalty abatement, send a statement to us fully explaining the facts. You or your representative with your power of attorney must sign your statement under penalty of perjury.

Under revenue procedure 84-35, some partnerships are presumed to meet the reasonable cause standard if they meet certain criteria. You may answer the questions on the next page and return them to us in the envelope provided so that we may determine whether you qualify for abatement of this penalty under revenue procedure 84-35. Before you return the questionnaire to us, make sure that each partner's name and Social Security Number or Taxpayer Identification Number is listed in the space provided and that each partner or his or her representative with a power of attorney signs the questionnaire under the penalties of perjury.

Questions:

1. Is the partnership a domestic partnership?
2. Does the partnership have 10 or fewer partners? (husband and wife and their estate are treated as one partner)
3. Are all partners natural persons (other than a nonresident alien) or an estate of a deceased partner?
4. Is each partner's share of each partnership item the same as his share of every other item?
5. Have all the partners timely filed their income tax returns?
6. Have all the partners fully reported their share of the income, deductions, and credits of the partnership of their timely filed income tax returns?

If the correct answers to all of the above questions are "Yes," the Service will abate this penalty.

If you have any questions or need further assistance in this matter, please contact Inga Plucinski at 202-622-3620.

CURTIS G. WILSON

By: /s/ Ashton P. Trice
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Senior Technician Reviewer
Branch 2