

Office of Chief Counsel  
Internal Revenue Service  
**Memorandum**

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subject: Rev. Proc. 81-11 and Rev. Proc. 84-35

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether Rev. Proc. 84-35, 1984-1 C.B. 509, *superseding* Rev. Proc. 81-11, 1981-1 C.B. 651, provides an automatic exemption to partnerships from the requirement of filing a Form 1065, *U.S. Return of Partnership Income*.

SUMMARY CONCLUSION

No. Neither I.R.C. § 6031 nor I.R.C. § 6698 contain an automatic exception to the general filing requirement set forth in I.R.C. § 6031(a). Although the I.R.C. § 6698 penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause, such relief may be granted under Rev. Proc. 84-35 if the partnership meets its requirements and examiners follow the procedures set forth in IRM 20.1.2.3.3.1.

## BACKGROUND

You have asked if Rev. Proc. 84-35 provides an automatic exemption to partnerships from the requirement of filing a Form 1065. Those revenue procedures provide that a domestic partnership with 10 or fewer partners that falls within the exceptions in I.R.C. § 6231(a)(1)(B) is deemed to have met the reasonable cause test, and, therefore, would not be liable for the I.R.C. § 6698 penalty. You contend that although the partnership is not relieved of the filing requirement, there is almost automatic reasonable cause relief for the failure to file a partnership return.

## LAW AND ANALYSIS

### Partnership Return Filing Requirement

Section 6031 of the Code requires every partnership (as defined in section 761(a)) to file a return for each taxable year.<sup>1</sup> 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.

### The Section 6698 Failure to File Penalty

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.<sup>2</sup> 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.<sup>3</sup> The penalty is computed at a rate of \$195 multiplied by the total number of partners in the partnership during any part of the tax year for which the return was due.<sup>4</sup> The amount of the penalty is adjusted for inflation for partnership returns required to be filed after the 2014 calendar year.<sup>5</sup> The penalty is assessed directly against the partnership.<sup>6</sup> It may be imposed in addition to the criminal penalties under section 7203.<sup>7</sup> Deficiency procedures do not apply.<sup>8</sup>

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<sup>1</sup> I.R.C. § 6031(a).

<sup>2</sup> See generally I.R.C. § 6698.

<sup>3</sup> I.R.C. § 6698(a).

<sup>4</sup> I.R.C. § 6698(b).

<sup>5</sup> I.R.C. § 6698(e).

<sup>6</sup> I.R.C. § 6698(c). 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.

<sup>7</sup> I.R.C. § 6698(a).

<sup>8</sup> I.R.C. § 6698(d).

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.<sup>9</sup> 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 Internal Revenue Service (Service) and reasonable cause is not established.<sup>10</sup> 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.<sup>11</sup>

#### Reasonable Cause Relief

Neither section 6031 nor section 6698 contains 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.<sup>12</sup> 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.<sup>13</sup>

#### Revenue Procedure 84-35

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,

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<sup>9</sup> IRM 20.1.2.3.1(1) (7-18-2016).

<sup>10</sup> IRM 20.1.2.3.1(4) and (5) (7-18-2016).

<sup>11</sup> See generally Penalty Relief, IRM 20.1.2.3.3 (02-02-2013). See also IRM 20.1.1.3, *Criteria for Relief From Penalties*, for a discussion of penalty relief, and IRM Exhibit 20.1.1-2, *Penalty Reason Code Chart*, for the appropriate PRC. See IRM 20.1.2.3.4, *Procedures for Assessment and Abatement*, for additional instructions.

<sup>12</sup> I.R.C. § 6698(a).

<sup>13</sup> See H. REP. NO. 95-1445, at 249 (1978).

1984-1 C.B. 509, *superseding* Rev. Proc. 81-11, 1981-1 C.B. 651. In relevant part, the revenue procedure provides:

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.

#### Rev. Proc. 84-35 Does Not Provide Automatic Relief In Every Case

Although Rev. Proc. 84-35 does provide some relief for failure to file a partnership return, we disagree that the guidance provides for almost automatic reasonable cause relief for the failure to file a partnership return. 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 partnership return 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.

Moreover, 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 not covered by Rev. Proc. 84-35.<sup>14</sup> In addition, 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.”<sup>15</sup> In that case, the

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<sup>14</sup> *Id.*, § 3.02. 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.

<sup>15</sup> *Id.*, § 3.03.

determination of reasonable cause must generally be made on a case-by-case basis, taking all of the relevant fact and circumstances into consideration.<sup>16</sup>

#### Criteria For Relief under Rev. Proc. 84-35

While Revenue Procedure 84-35 does not exempt every small partnership from the application of section 6698, it set forth criteria under which the Service will agree that a small partnership meets the reasonable cause test of section 6698.<sup>17</sup> Under these criteria, although 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, the Service may alternatively require the partners or the partnership to establish that the partners have in fact fully complied with their filing requirement.<sup>18</sup>

Accordingly, the Service has set forth procedures for applying Rev. Proc. 84-35. See IRM 20.1.2.3.3.1 (07-18-2016). That section of the IRM provides that the I.R.C. § 6698 penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause, by meeting the following requirements:

1. The partnership must consist of 10 or fewer partners. For the purpose of this requirement, a husband and wife (or their estate) filing a joint return is considered one partner.
2. Each partner is either an individual (excluding nonresident aliens), or the estate of a deceased partner.
3. Each partner's items of income, deductions, and credits are allocated in the same proportion as all other items of income, deductions, and credits.
4. The partnership has not elected to be subject to the consolidated audit procedures under I.R.C. §§ 6221 through I.R.C. § 6233.
5. Each partner reported his or her share of partnership income on his or her **timely filed** income tax return. (emphasis added).<sup>19</sup>

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<sup>16</sup> See Reasonable Cause, IRM 20.1.1.3.2(1) (11-25-2011)

<sup>17</sup> Rev. Proc. 84-35 § 3.01.

<sup>18</sup> *Id.*

<sup>19</sup> IRM 20.1.2.3.3.1(2). See *Battle Flatt, LLC v. United States*, 116 AFTR2d 2015-6193, 2015 WL 5554907 (D. S.D. 2015) (Rev. Proc. 84-35 enforced as the Service's interpretation that partners in a "small" partnership timely file their personal income tax returns is reasonable and is consistent with the legislative history in that it strains credulity to characterize a personal income tax return filed years after the reporting deadline as an adequate, full reporting of each partner's share of the partnership's income and deductions).

In addition, IRM 20.1.2.3.3.1(3) instructs examiners that when a partner requests abatement of the failure to file penalty because the partnership has ten partners or fewer, abate the penalty if the partner (or representative) confirms verbally or in writing that—

1. All partners are qualifying partners,
2. All partners filed timely returns and included their share of partnership income on that return, and
3. The partnership is not subject to the consolidated (unified) audit procedures under I.R.C. §§ 6221 through I.R.C. 6234.<sup>20</sup>

Moreover, the IRM instructs examiners that to the greatest extent practical, they should validate the taxpayer's statements by using CFOL to research each partner's account for timely filing, and should not abate the penalty if the examiner finds that any partner filed late, or if any partner failed any other requirement.<sup>21</sup>

#### Meeting the 84-35 Requirements Encourage Voluntary Compliance

Finally, penalties exist to encourage voluntary compliance and support the standards of behavior expected under the Internal Revenue Code by demonstrating the fairness of the tax system to compliant taxpayers and increase the cost of noncompliance.<sup>22</sup> In considering the application of penalties to a particular case, the Service should be consistent in the application of penalties in similar cases, apply unbiased analysis of the facts in each case, and properly apply the law to the facts of the case.<sup>23</sup> In addition, the taxpayers against whom the penalty is imposed must be given an opportunity to have their interests heard and considered.<sup>24</sup> Requiring taxpayers to meet the requirements of Rev. Proc. 84-35 and IRM 20.1.2.3.3.1 encourages voluntary compliance by reminding taxpayers of the requirement to timely file partnership returns and their own individual returns and that their individual income tax returns include their share of partnership income.<sup>25</sup>

### CONCLUSION

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<sup>20</sup> IRM 20.1.2.3.3.1(3).

<sup>21</sup> IRM 20.1.2.3.3.1(4).

<sup>22</sup> See generally Penalty Policy Statement 20-1 (06-29-2004), IRM 1.2.20.1.1(3).

<sup>23</sup> IRM 1.2.20.1.1(8).

<sup>24</sup> IRM 1.2.20.1.1(9).

<sup>25</sup> See *Battle Flatt, LLC v. United States* at note 19.

Accordingly, we conclude that Rev. Proc. 84-35 does not provide an automatic exemption to partnerships from the requirement of filing a Form 1065. Neither I.R.C. § 6031 nor I.R.C. § 6698 contain an exception to the general filing requirement set forth in I.R.C. § 6031(a). Although the I.R.C. § 6698 penalty may be avoided if it is shown that the failure to file a complete or timely return was due to reasonable cause, such relief may be granted under Rev. Proc. 84-35 if the partnership meets its requirements and examiners follow the procedures set forth in IRM 20.1.2.3.3.1.

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Please call (202) 317-5417 if you have any further questions.