

TREASURY RECOMMENDS TOUGHER SANCTIONS AGAINST LATE-FILING PASS-THROUGH ENTITIES

The Treasury Inspector General for Tax Administration (TIGTA), after a review of the filing compliance record of pass-through entities, has found filing noncompliance by partnerships and S corporations to be at "an unacceptably high level." The IG calls for stronger sanctions, including increased penalties and stricter application of the penalty provisions.

■ **Background**

Partnerships and S corporations are required to file income tax returns, but generally are not subject to income tax. Instead, their profits or losses pass through to their respective partners or shareholders. Partners and shareholders report their share of the entity's profit or loss on their individual income tax returns.

The due date for filing partnership returns (Form 1065) is the 15th day of the fourth month following the close of the partnership's tax year (i.e., April 15th for a calendar year partnership). The normal due date for filing an S corporation return (Form 1120S) is the 15th day of the third month following the close of the tax year (March 15th for a calendar year S corporation).

Observation: Even when the partnership or corporation files its return on time, partners and S corporation shareholders are often inconvenienced and have difficulty filing their own returns on a timely basis without extension because they receive their K-1 schedules so close to the April 15th due date of their individual returns.

Observation: Partnerships and S corporations can obtain automatic extensions of time to file-3 months for a partnership by filing Form 8736; 6 months for an S corporation by filing Form 7004. Partnerships and S corporations that are on extension can thus delay the completion of their returns and delivery of the K-1 schedules to their partners or shareholders until virtually the expiration of even an extension of time to file an individual return.

The Code Sec. imposes a penalty for failure to timely file a partnership return. The penalty is \$50 per partner for each month (or fraction of a month) that the return is filed late, up to a maximum of 5 months. Thus, the maximum penalty is \$250 per partner.

Illustration : X, a calendar year partnership with 4 partners files its return on May 1st. Since the return was filed within one month of its April 15th due date, the maximum penalty is \$200 (\$50 [for one month] × 4 partners).

Illustration : If X doesn't file its return until December 1st, the maximum penalty is \$1,000 (\$50 × 5 months × 4 partners).

Observation: Although S corporations also act as pass-through entities, they aren't subject to a late filing penalty comparable to the one which partnerships

are subject to.

Under Revenue procedures, small partnerships (10 or fewer partners) which file late may qualify for a reasonable cause exception and have the penalties abated. To qualify, the partnership must establish, if so requested by IRS, all partners have fully reported their share of the partnership's income, deductions and credits on their timely filed individual returns.

Observation: IRS generally will accept a statement on a late filed partnership return that the requirements have been met, without requiring further information establishing that fact. Thus, many small partnerships are able to avoid paying penalties for late filing.

Observation: A limited liability company (LLC) is classified as a partnership for tax purposes unless corporate classification is elected. Thus, a nonelecting LLC files its return on Form 1065, U.S. Return of Partnership Income. The IRS has asserted the penalty against late filing LLCs (on the basis of the number of members), and also has abated the penalties in the case of LLCs which meet the requirements of 10 or fewer members.

■ **Inspector General's criticism of current system**

The report of the Treasury IG for Tax Administration finds fault with the current policies and practices with respect to filing compliance of pass-through entities:

- Noncompliance by partnerships and S corporations is at an unacceptably high level. The incidence of late filed partnership and S corporation returns is nearly 2 to 4 times higher than among individual taxpayers. Moreover, the incidence of late-filed returns is growing rapidly; up more than 20% between 2000 and 2003. More than 25% of the late-filed returns were delinquent by 6 months or more.
- The effectiveness of the penalties intended to prevent noncompliance has been eroded by inflation and they are generally not applicable to S corporations. The amount of the penalty for a late-filed partnership return has not been increased since it was first imposed in 1978. To generate the same economic impact on a late-filed partnership return today, the penalty would have to be about \$145 per partner per month. In addition, the absence of penalties for late-filed S corporation returns is an unfair aspect of the tax system, and implies accountability for pass-through income from S corporations is less significant than that from partnerships.
- Noncompliance by the pass-through entities adversely affects the compliance of partners and S corporation shareholders whose returns are due on April 15th. The Inspector General estimates there were 1.7 million partners and shareholders in the pass-through entities which filed late in tax year 2001. In many cases, the partners and shareholders filed their returns before the pass-through returns were filed. A check found only 78% of them were fully compliant in both timely filing their individual returns and fully reporting the information from their K-1 schedules.

Observation: Although more elaborate, the Schedule K-1 serves the same general purpose for a partner or shareholder as a Form W-2 does for an individual employee. However, the W-2 must generally be furnished to an employee by January 31st.

■ **Inspector General's recommendations**

To address these issues, the Inspector General's report says the IRS should consider amending the tax regulations and/or developing legislative proposals which would eliminate the automatic reasonable cause exception for late-filed small partnership returns; more severely restrict the reasonable cause exception for late filing penalties for partnership returns filed after the extended due date; and make the late filing penalties applicable to S corporations as well as partnerships. The recommendations would also remove the 5-month limitation on the number of months of delinquency for which the late-filing penalty is assessed on partnership returns; permit IRS, when a partnership or S corporation return is filed late, to automatically assess the penalty for the failure to timely furnish payee statements to IRS; in the case of a partnership or S corporation return filed more than 7 days after its due date, permit IRS to automatically assess a penalty for the failure to timely provide payee statements to the individual partners or shareholders; and increase the penalty for late-filed returns and payee statements from \$50 to \$200 (at a minimum). These steps would result in penalties of \$600 per partner or shareholder for the first month of filing delinquency, and an additional \$200 penalty per partner or shareholder for each additional month of filing noncompliance.

■ **IRS response**

The Commissioner of IRS's Small Business/Self-Employed Division disagrees with the proposal to eliminate the automatic reasonable cause exception for small partnerships, saying the Revenue Procedure was consistent with Congressional intent. IRS also disagrees with the proposal to eliminate the reasonable cause exceptions for late filing penalties when a partnership files its return after the extension date has passed, asserting there was no data showing doing so would result in increased compliance. With respect to the remaining proposals, IRS feels further study, as well as input and concurrence from the Treasury Office of Tax Policy, are necessary before they can be implemented.

Observation: Despite the comments made by the Commissioner of IRS's Small Business/Self-Employed Division, the TIGTA report may lead to changes designed to improve compliance. Partnerships and other pass-through entities, i.e, S corporations, LLCs, and trusts, should review their return preparation and filing procedures with a view to meeting filing deadlines and otherwise improving compliance.

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