

August 25, 2014

Potential Tax Traps for Partnerships and LLCs - Short Years and Late Filing Penalties

When a partnership (or LLC taxed as a partnership) terminates, the taxable year of the partnership ends on the date of termination, and a final income tax return is due within three and a half months from that date. As the **PENALTIES FOR LATE FILING CAN BE SEVERE**, it is critical for partnerships to recognize when a termination occurs and that a short period filing may be due before the usual April 15th deadline.

Termination of a Partnership

A partnership is considered to have terminated when either of the following occurs:

- The partnership ceases to do business, or
- There is a sale or exchange of 50% or more of the total interests in capital and profits within a 12-month period (not necessarily a calendar year), including sales or exchanges between partners.

A partnership ceases doing business when it discontinues all of its operations and has wound up its affairs. This event is much easier to identify than the second. Under the latter scenario, also called a technical termination, the partnership may continue its normal operations without even realizing a termination has occurred, and that a short period tax return is due, until well after the deadline has passed.

Example - Partnership Z has 5 equal partners (A, B, C, D, and E) and a calendar tax year. On June 30, 2013, Partner A sold a 15% interest to a new partner, F. On November 30, 2013, Partner B sold a 15% interest to Partner C. On April 30, 2014, Partner D sold his entire 20% interest to Partner E.

There is a technical termination of the partnership on April 30, 2014, because there was, in aggregate, a sale or exchange of 50% or more of the interests in the partnership within a 12-month period. The taxable year ends on April 30, 2014, and a new partnership is deemed to be formed on May 1st. There will thus be two short period returns due for 2014: a final tax return for January 1st through April 30th due August 15, 2014, and an initial tax return for May 1st through December 31st, due April 15, 2015.

Late Filing Penalties –

The penalty for federal is \$195 for each month or part of a month (for up to 12 months), multiplied by the total number of partners in the partnership during any part of the partnership's tax year for which the return is due. California computes its penalties the same way, at \$18 per month or partial month.

Depending on the number of partners in the partnership, the penalties can quickly add up:

In our example above, if Partnership Z doesn't realize it had a technical termination and files both of its short period returns on April 15, 2015, total penalties for late filing of the Federal and California tax returns for the first short period would be \$10,224, plus interest.

Please keep this in mind and consult with us throughout the year if you believe any of the above may apply to your partnership or LLC.

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