

Tax Treatment of Husband/Wife LLCs

MANY HUSBANDS AND WIVES might consider themselves a partner in their spouse's business, but when is the arrangement a true partnership? The answer to the simple question—does a partnership exist?—is often anything but simple. A partnership return might be required for a business operated jointly by a husband and wife, even if the husband and wife file a joint personal income tax return.

The issue of determining partnerships has come to the forefront as Congress recently increased the penalties for failing to file a partnership return. These enhanced penalties make it even more important to evaluate whether businesses operated by husband and wife should file a federal partnership income tax return (Form 1065).

ENHANCED FAILURE-TO-FILE PENALTIES

In November, President Obama signed into law the Worker, Homeownership, and Business Assistance Act of 2009. Two parts of this Act received the bulk of public attention: the extension and expansion of the homebuyer's credit, and an extended carryback period for net operating losses. However, among such taxpayer-friendly provisions, the Act also contains a provision that increases the penalty for failure to file a partnership or S corporation return. Under prior law, the penalty was \$89 per month, capped at \$1,068. Under the new law, the penalty is increased to \$195 per month, capped at \$2,340. In light of the increased penalties for failing to file a partnership return, it is important to consider whether you are engaged in a partnership for which no federal income tax return is currently prepared.

WHEN A PARTNERSHIP IS FORMED

As is true under state law, a partnership for federal income tax purposes is easy to form and might be formed unintentionally. For federal income tax purposes, Internal Revenue

Code Section 7701(a)(2) defines a partnership as “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation.” Under this definition, the operation of an active trade or business by two or more individuals is generally deemed a partnership. This is true even though the two individuals are husband and wife and irrespective of whether the business is operated within or without a non-corporate, state-law entity, such as a partnership or limited liability company.

QUALIFIED JOINT VENTURES

The Small Business and Work Opportunity Tax Act of 2007 carved out a narrow exception to the general classification of a business owned and operated by husband and wife as a partnership. For tax years beginning after 2006, IRC Section 761(f) permits a “qualified joint venture” to elect not to be treated as a partnership. A “qualified joint venture” is defined narrowly as follows: “a joint venture involving the conduct of a trade or business, [so long as] . . . (1) the only members . . . are a husband and wife, (2) both spouses materially participate, and (3) both spouses elect not to be treated as a partnership.”

The IRS has taken the position that a business operated from inside a state-law entity, such as a general or limited liability company, cannot qualify as a qualified joint venture. Accordingly, the IRS views a spouse-operated business within an LLC as a partnership for which a partnership return must be filed. Although the IRS has not disclosed the rationale for its position, the position is likely the result of the definition of a “joint venture.” As the term is generally understood, a joint venture is a business undertaking by two or more persons engaged in a single, definite project. It is generally understood as something more limited than a state-law partnership. The operation of

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Husband/Wife LLCs, *continued from front*

a business in a state-law entity would likely imply a more expansive enterprise, and not a single, definite project.

Below are two examples to illustrate these points.

- (1) Husband and Wife jointly operate a local retail store. Each participates in managing the store, which is operated outside a state-law entity.

For federal income tax purposes, there is likely a partnership because there is more than one person joined together in a continuous activity for profit. Under the check-the-box regulations, the business will be taxed as a partnership (absent other elections). However, after 2006, Husband and Wife can elect to have the business' activities reported 50/50 on each spouse's 1040 (Schedule C) as a qualified joint venture.

- (2) Same circumstances as the first example, except that Husband and Wife consulted with their attorney, who advised them to contribute the business property to a new member-managed LLC. Each of Husband and Wife took a 50 percent LLC interest.

There is still a partnership for federal income tax purposes. The LLC will be taxed as a partnership, absent other elections, and the IRS would require the LLC to file a partnership return. The operation of the business from within an LLC implies a more extensive and long-lasting arrangement than a joint venture; accordingly, the qualified joint venture election is not available to avoid a partnership return.

In light of the increased failure-to-file penalties, we encourage you to consider whether you and your spouse have taken a filing position contrary to the IRS position. If you are in doubt, we would be delighted to assist you in correctly and accurately satisfying your reporting obligations in a manner that minimizes both potential IRS scrutiny and filing penalties.



Contact John E. Weaver, CPA at (573) 442-6171 for more information regarding the tax treatment of partnerships and LLCs.

COBRA subsidy expanded and extended

ON DECEMBER 19, President Obama signed into law H.R. 3326, the Department of Defense Appropriations Act of 2010, which includes provisions related to COBRA insurance for all workers. The law takes effect immediately.

H.R. 3326 includes an unemployment insurance eligibility extension and a six-month extension in the maximum COBRA premium subsidy period, from 9 months to 15 months. H.R. 3326 extends eligibility for the subsidy to those who lose their jobs during the first two months of 2010. The new law also includes transition period relief for eligible individuals who had reached the end of the reduced premium period before the law was signed. These individuals may elect to pay reduced COBRA premiums retroactively and thus maintain their COBRA coverage for the expanded subsidy period.

Employers should take note of the new notification requirements included in the law. H.R. 3326 requires the health plan administrator to provide additional notification about the new subsidy provisions to individuals who are eligible on or after October 31, 2009, and to individuals who experience a qualifying event relating to COBRA continuation coverage on or after that date.

Details regarding COBRA coverage assistance under ARRA are available at www.dol.gov/cobra.



For more information on COBRA provisions, contact Debbie Mathes at (573) 442-6171.

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