Alternative investment tax matters

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This *Alternative Investment Tax Matters* article revises and supersedes the updated article issued March 9, 2020. This article was first revised for an updated version of the Form 1065 Instructions (Updated Instructions) released by the Internal Revenue Service (IRS) on February 19, 2020. On March 26, 2020, the IRS published Clarifications for Disregarded Entity Reporting and section 743(b) Reporting (the DE FAQs). The DE FAQs include some needed clarification on disregarded entity partner reporting however, some questions still remain. The article below has been revised to incorporate the DE FAQs.

The IRS recently finalized the following tax year 2019 partnership information returns: Form 1065, *U.S. Return of Partnership Income*; Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*; Schedule K-1 (Form 1065 and Form 8865), *Partner's Share of Income, Deductions, Credits, etc.,* (collectively, the Forms); and corresponding instructions (the Instructions). On February 19, 2020, the IRS released an updated version of the Form 1065 instructions. The Forms and the Instructions introduce new reporting requirements that are likely to enhance the IRS's ability to assess compliance risk and identify potential noncompliance when auditing partnerships under the new partnership audit regime, the Bipartisan Budget Act of 2015 (the BBA).

Note that the conclusions reached in this article are based on our interpretation of the Forms and Updated Instructions, the DE FAQs, and informal conversations with the IRS. The discussion and conclusions below are subject to change as additional guidance from the government is released.

Updated reporting requirements

One of the most discussed changes to the Forms and Instructions is the expanded disregarded entity reporting on Schedule K-1 (Form 1065).[1] Specifically, Schedule K-1 (Form 1065) was updated to add a new checkbox to indicate if the partnership interest is owned through a disregarded entity (a DE Partner). Lines were added to the Schedule K-1 (Form 1065) to request the DE Partner's tax identification number (TIN) and name. The Schedule K-1 (Form 1065) and the Instructions make clear that the information reportable in Part II, Items E and F, should not be that of the DE Partner but rather should be that of the beneficial owner of the DE Partner (the Taxpayer Partner). The IRS provided clarification in both the Updated Instructions and DE FAQs (FAQ 1 for the reporting for Item I1 of Schedule K-1 (Form 1065), which asks for the partner's entity type. The Updated Instructions and DE FAQs indicate that the entity type reported should be that of the Taxpayer Partner, not the entity type of the DE Partner.

Our understanding is that the DE Partner reporting changes were intended to ensure that the partner TIN, name, and address that are reported on Schedule K-1 are that of the Taxpayer Partner and not of the DE Partner. While the requirement to report the Taxpayer Partner information was incorporated in the Form 1065 instructions since 2004, it is our understanding that the partner information reporting is not consistently executed in practice, prompting more specific line item updates. It is expected that the expanded reporting will assist the IRS in matching the income reported on the Schedule K-1 (Form 1065) to the Taxpayer Partner's return; matching would necessarily be hampered in cases where the DE Partner information was reported on Schedule K-1 instead of the Taxpayer Partner information. The checkbox denoting whether the interest is owned through a DE Partner was likely added to clarify the ownership structure and possibly for purposes of the BBA because a partnership with a disregarded entity partner cannot elect out of the new partnership audit regime.

The new DE Partner reporting requirements leave open several questions, some of which were answered in the Updated Instructions and DE FAQs: however, other questions still remain.

Summary of DE Partner Reporting Requirements – Schedule K-1 (Form 1065)

Part II, Item E: Report the SSN or TIN of the Taxpayer Partner. The Schedule K-1 (Form 1065) was updated to denote that the TIN of the DE Partner should not be used; instead, the SSN or TIN of the Taxpayer Partner is reported in Item E.

Part II, Item F: Report the name and address of the Taxpayer Partner. The Schedule K-1 (Form 1065) was updated to denote that the name and address of the DE Partner should not be used; instead, the name and address of the Taxpayer Partner is reported in Item F.

Part II, Item H2: If the partnership interest is owned through a DE Partner, check the box and report the TIN and name of the DE Partner. The Updated Instructions provide that partnerships should make "reasonable attempts" to obtain the DE Partner's TIN. If, after making reasonable attempts to obtain the DE Partner's TIN, such TIN is unavailable or unknown to the partnership, the partnership should report "unknown" on the TIN line. To the extent the DE Partner does not have its own TIN, partnerships should report "none" on the TIN line.

Part II, Item I1: Report the entity type of the Taxpayer Partner.

Open items

The above reporting requirements do not address how to report the DE Partner ownership in various scenarios where the partnership interest is owned legally through several single-member limited liability companies that are treated as disregarded entities (SMLLCs), or grantor trusts, as illustrated below. Though the DE FAQs addressed some of these items, other questions still remain.

Scenario 1 – Taxpayer Partner owns its interest through tiers of disregarded entities:

Corporation A owns SMLLC 1, which in turn owns SMLLC 2. SMLLC 2 legally owns the interest in Partnership B. The question is whether SMLLC 1 or SMLLC 2 (or both) would be considered a DE Partner in Partnership B that needs to be disclosed on Item H2.

KPMG's observation: If the partnership interest is owned by tiered SMLLCs, DE FAQ 2 indicates that the partnership must report in Item H2 the TIN and name of the SMLLC (i.e., SMLLC 2), which is the legal owner of the partnership interest.

Scenario 2 – Taxpayer Partner owns interests in a partnership through multiple direct disregarded entities:

Corporation A owns both SMLLC 1 and SMLLC 2, and each disregarded entity legally owns an interest in Partnership B. Both SMLLC 1 and SMLLC 2 would be considered DE Partners in Partnership B.

KPMG's observation: This scenario was not addressed in the DE FAQs. It seems appropriate to include a statement to Item H2 of the Schedule K-1 (Form 1065), disclosing both SMLLC 1 and SMLLC 2 as DE Partners.

Scenario 3 – Taxpayer Partner owns direct and indirect interests (through a direct disregarded entity) in a partnership:

Corporation A owns a direct interest in Partnership B and also owns SMLLC 1. SMLLC 1, in turn, legally owns an interest in Partnership B. SMLLC 1 would be considered a DE Partner in Partnership B with respect to the interest held by SMLLC 1.

KPMG's observation: This scenario was not addressed in the DE FAQs. It seems appropriate to include a statement to Item H2 of the Schedule K-1 (Form 1065) indicating that the interest is held in part directly by Corporation A and in part indirectly through SMLLC 1 as a DE Partner.

Scenario 4 – Partnership interest owned through a wholly owned grantor trust, and the grantor is required to or chooses to file a return, which is separate from the grantor:

Individual A owns its interest in Partnership B through Grantor Trust 1. Grantor Trust 1 is required to or chooses to file a federal tax information return on Form 1041, *U.S. Income Tax Return for Estates and Trusts*, that includes Grantor Trust 1's distributive share of tax items allocated from Partnership B.

KPMG's observation: Per DE FAQ 3, a wholly owned grantor trust that has a filing obligation will be treated like a disregarded entity for purposes of reporting the information required by Item H2. Accordingly, where a wholly owned grantor trust that files a Form 1041 is the legal owner of a partnership interest, the grantor trust's information will be reported in Item H2. Items E and F should contain information on the owner (under Subpart E of Subpart J) of the wholly owned grantor trust. This would mean Individual A should be reported as the Taxpayer Partner and Grantor Trust 1 as the DE Partner on the Schedule K-1 (Form 1065). The prior version of this article recommended that it would be reasonable to treat Grantor Trust 1 as the Taxpayer with no DE Partner reporting on the Schedule K-1 (Form 1065) given that the intent of the reporting requirements was to enable matching of Schedule K-1 (Form 1065) items to a tax return. The authors note that the conclusion in the DE FAQs deviate from our earlier recommendation.

Scenario 5 – Partnership interest owned through a grantor trust, and the grantor is not required to (and does not otherwise choose to) file a return, which is separate from the grantor:

Individual A owns its interest in Partnership B through Grantor Trust 1. Grantor Trust 1 is not required to (and does not otherwise choose to) file a federal tax information return. Individual A includes Grantor Trust 1's share of items allocated from Partnership B directly on his or her tax return.

KPMG's observation: While not specifically addressed by the DE FAQs, DE FAQ 3 seems to imply that the requirement to report information with respect to a wholly owned grantor trust in Item H2 is not conditioned on the grantor trust's other tax return filing requirements. Thus, consistent with Scenario 4, it appears that Individual A should be reported as the Taxpayer Partner and Grantor Trust 1 as the DE Partner on the Schedule K-1 (Form 1065).

Validity of FAQs

FAQs posted on IRS.gov that are not also published in the Internal Revenue Bulletin (IRB) are generally not considered published guidance or legal authority.[2] However, FAQs that are published in the IRB or are otherwise incorporated into the IRB by a document that is published in the IRB, that is a notice or announcement, are treated as published guidance upon which taxpayers may rely. Additionally where FAQs are incorporated within a set of instructions, they become binding on a taxpayer (e.g., the negative tax basis capital account FAQs were incorporated in the Instructions and, thus, are binding on the taxpayer for 2019). In addition, FAQs can be added to, edited, and/or removed by the IRS at any given time and without notice. The FAQs discussed in this article have not been published or otherwise incorporated within the IRB or Instructions and, thus, are not considered published guidance or legal authority. While this creates uncertainty, it also may provide opportunity for the partnership to either rely or not rely on the FAQ. In the instant case, it seems reasonable to follow the approaches discussed above as incorporated in the DE FAQs; however, there may be other reasonable approaches that the taxpayer could take, (e.g., to treat a grantor trust that files separately from the grantor as a Taxpayer Partner) and would still be valid unless and until the DE FAQs are incorporated in the IRB or Instructions.

Requesting information

For purposes of determining whether a partner is a DE Partner or a Taxpayer Partner, the Instructions indicate that the partnership should inquire whether any partner that is a limited liability company (LLC) or a trust is a disregarded entity for U.S. federal income tax purposes. Additionally, if the partnership decides to deviate from the DE FAQs with regards to the grantor trust reporting, and follow the authors' prior recommendation differentiating reporting between a grantor trust that files separately from the grantor and one that does not, the partnership will need to inquire as to whether the grantor trust either has a separate filing obligation from the grantor, as outlined under Treas. Reg. section 1.671-4(b)(2), or otherwise chooses to file separately from the grantor to determine whether the grantor trust is a DE Partner or a Taxpayer Partner.

Where the LLC or trust is a DE Partner, the partnership should request the name, TIN, and address of the Taxpayer Partner and the name and TIN of the DE Partner. It is common practice for partnerships to request Form W-9, *Request for Taxpayer Identification Number and Certification*, from each partner. The form generally provides the name, TIN, address, entity type of the Taxpayer Partner, and the name of the DE Partner. Form W-9 does not currently disclose the TIN of the DE Partner. The Updated Instructions state that the partnership should make "reasonable attempts" to obtain a DE Partner's TIN. As noted above, to the extent the TIN is unavailable or unknown, the partnership should enter "unknown" in the space for the DE Partner's TIN. Hopefully, the IRS will update the Form W-9 to include the TIN of a DE Partner in light of the new reporting requirements on the Schedule K-1 (Form 1065).

Consistent with prior practice, partnerships should work with their partners to ensure that ownership changes are accounted for and any new partner information is obtained.

Penalty considerations

Where a partnership does not complete the Schedule K-1 (Form 1065) completely and accurately, it may face penalties under section 6722 for failure to furnish correct payee statements to its partners. The section 6722 penalty applies when a taxpayer either fails to furnish a Schedule K-1 (Form 1065) or furnishes an incomplete or inaccurate Schedule K-1 (Form 1065). For the 2019 tax year, the penalty is $270 for each incomplete Schedule K-1 (Form 1065) up to a maximum of $3,339,000. This penalty can be reduced to $50 for each Schedule K-1 (Form 1065) if the taxpayer corrects the error within 30 days or $110 for each Schedule K-1 (Form 1065) if corrected after 30 days but before August 1 of the year due. Lower maximum limits apply to persons with gross receipts less than $5 million. In the case of intentional disregard, however, the penalty increases to $550 per Schedule K-1 (Form 1065) with no maximum cap.

Taxpayers may raise a reasonable cause defense to the penalty. To qualify for reasonable cause relief, there must be (a) significant mitigating factors or (b) the failure must be due to events beyond the filer's control. For either condition to apply, the filer must have acted in a responsible manner. The unavailability of records is listed in the regulations as an indication of events beyond a filer's control, but it does not constitute reasonable cause without the taxpayer having acted in a responsible manner. The regulations state that acting in a responsible manner requires that the filer exercise reasonable care, which is the standard of care that a reasonably prudent person would use under the circumstances, and that the filer undertake significant steps to avoid or mitigate the failure.

In the context of the DE Partner reporting requirement, consideration needs to be given to the ability to assert that a partnership acted in a responsible manner (i.e., the exercise of reasonable care by a prudent person under the circumstances). At a minimum, we recommend that the partnership requests the necessary information from its partners and retain documentation of the requests and the responses (or lack of responses).

[1] The Schedule K-1 (Form 8865) has similar updates.

[2] I.R.M. Section 4.10.7.2.4 (01-10-2018)

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