KPMG

Alternative investment tax matters

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The Internal Revenue Service (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). The Forms and 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 Instructions 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 check box 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 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). Further, in asking for the partner's entity type, on Part II, Item I1 of Schedule K-1 (Form 1065), KPMG believes the intent of the IRS is to have the partnership report the entity type of the Taxpayer Partner, not the entity type of the DE Partner. This is despite the instructions to Item I1 indicating that the partnership should "state whether the partner is an individual, a corporation, an estate, a trust, a partnership, a *disregarded entity* [emphasis added], an exempt organization, a foreign government, or a nominee (custodian)."

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 is 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 lineitem 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 check box 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 as discussed in detail below.

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. To the extent the DE Partner does not have its own TIN, reporting as "NONE" or "N/A" on the TIN line is acceptable.

Part II, Item I1: Report the entity type of the Taxpayer Partner. While not free from ambiguity, KPMG believes the intent is to request the entity type of the Taxpayer Partner despite the availability of "DE" as a reporting option.

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:

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: It seems appropriate to report the identifying information of the direct legal owner of the Partnership B partnership interest on Item H2 (SMLLC2). It may also be appropriate to include a statement for Item H2 of the Schedule K-1 (Form 1065), listing both SMLLC 1 and SMLLC 2 as DE Partners.

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: 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: 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 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: Given that the intent of the reporting requirements is to enable the matching of Schedule K-1 (Form 1065) items to a tax return, it seems reasonable in this case to treat Grantor Trust 1 as the Taxpayer Partner, with no DE Partner reporting on the Schedule K-1 (Form 1065).

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: Given the intent of the reporting requirements, 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).

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 USFIT purposes. To the extent a partner is a grantor trust, the partnership should inquire whether the grantor 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 partnership must make additional requests to receive 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 request 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.

Contact information

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