Partnership Reporting Considerations: Selected Post-TCJA Issues

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Agenda

- Section 199A Reporting
- Section 163(j) Reporting
- Section 1061 Reporting
- Negative Tax Capital Account Reporting
Section 199A Reporting
Section 199A Overview

- Section 199A provides a potential 20% deduction with respect to an individual's share of qualified business income (QBI) from a partnership, S corporation, or sole proprietorship with a qualified trade or business (QTB)
  - Deduction is generally based on combined QBI amount
- Regulations contemplate that all partnerships that roll up to at least one individual, estate, or trust partner MUST apply Section 199A
  - Treas. Reg. §1.199A-(6)(b)(1): "An RPE must determine and report information attributable to any trades or businesses it is engaged in necessary for its owners to determine their Section 199A deduction"
- Creates burdensome reporting obligations for partnerships and other relevant passthrough entities (RPEs)
Limitations on Section 199A Deduction

• **Wage and Property Limitation**: The QBI amount for each QTB is the lesser of (1) 20% of QBI or (2) the greater of (i) 50% of the taxpayer's W-2 wages allocable to QBI, or (ii) the sum of 25% of W-2 wages allocable to QBI plus 2.5% of the unadjusted basis immediately after acquisition of the taxpayer's qualified property (the "UBIA" of qualified property).

• **Certain Businesses Excluded**: Higher income taxpayers are not eligible for a deduction under Section 199A with respect to the QBI amount from a specified service trade or business (SSTB).
Section 199A Reporting

- **Schedule K-1 line items**
  - Line 20Z – Section 199A income
  - Line 20AA – Section 199A W-2 wages
  - Line 20AB – Section 199A UBIA
  - Line 20AC – Section 199A REIT dividends
  - Line 20AD – Section 199A PTP income

- **Detailed (whitepaper) disclosures**
  - Reported for each trade or business directly conducted by the RPE
    - Entity name, EIN, and tax year end of RPE in which trade or business is operated
    - General description of trade or business
    - Whether the trade or business is an SSTB
    - If the trade or business was formed, acquired, or disposed during the year
    - QBI, W-2 Wages, UBIA, and Section 1231 gains for each trade or business
  - Reporting also required for trades and business conducted by a lower-tier RPE
Trade or Business Analysis

Required Steps

- RPE must determine if it conducts a trade or business
- If yes, RPE must determine whether there are multiple trades or businesses
- The RPE must determine whether each trade or business is (or is treated as) an SSTB

- Treas. Reg. § 1.199A-1 generally defines "trade or business" by reference to Section 162
  - Disregarded entities are disregarded for purposes of Section 199A
  - The Preamble to the Section 199A regulations provides that a single trade or business generally may not exist across multiple entities that are regarded for tax purposes
Aggregation at RPE Level

- **Optional Step**
  - RPE may choose to aggregate trades or businesses it operates directly or through lower-tier RPEs
    - NOT allowed in Proposed Regs but permitted under the Final Regs if requirements are met
    - Trades or businesses aggregated by an RPE cannot be disaggregated

- If an RPE chooses to aggregate trades or businesses, it must file a detailed "required annual disclosure"
  - Failure to file the "required annual disclosure" allows the Commissioner to disaggregate the RPE's trades or businesses; taxpayer may not aggregate trades or businesses that are disaggregated by the Commissioner for the subsequent three taxable years

- **Required annual disclosure must contain:**
  - A description of each trade or business;
  - The name and EIN of each entity in which a trade or business is operated;
  - Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year;
  - Information identifying any aggregated trade or business of an RPE in which the RPE holds an ownership interest; and
  - Such other information as the Commissioner may require in forms, instructions, or other published guidance
Qualified Business Income (QBI)

Required step

• QBI must be computed for each trade or business (or aggregated trades or businesses)

• QBI must be properly allocable to a trade or business

• QBI must be effectively connected income (ECI)
  ➢ ECI ≠ US source income
  ➢ Foreign-source income generally reported on a partnership tax return

• Current-year EBIE allocated in the current year should not reduce QBI
  ➢ Query the impact on QBI when EBIE is "freed"

• Query the impact of Section 743(b) adjustments on QBI
UBIA of Qualified Property: Excess 743(b) Basis Adjustments

- "Excess Section 743(b) basis adjustments" are treated as separate item of qualified property placed in service when the transfer of the partnership interest occurs
- Defined as a recalculation of a partner's Section 743(b) adjustment as if the partnership's adjusted basis in the property was equal to the UBIA of such property
- Absolute value of the "excess Section 743(b) basis adjustment" cannot exceed absolute value of the Section 743(b) adjustment

- Proposed Section 199A regulations provided that Section 743(b) basis adjustment were not qualified property; rules were changed in response to comments

- Are excess Section 743(b) basis adjustment being reported in practice?
Tiered Partnership Issues

Required Step:

• On-reporting
  • Treas. Reg. § 1.199A-6: "An RPE must report on an attachment to the Schedule K-1, any QBI, W-2 wages, UBIA of qualified property, or SSTB determinations, reported to it by any RPE in which the RPE owns a direct or indirect interest"
  • Treas. Reg. § 1.199A-4: "An RPE also must report aggregated trades or businesses of a lower-tier RPE in which the RPE holds a direct or indirect interest"
### Tiered Partnership Issues - Trade or Business Detail – No Aggregation

<table>
<thead>
<tr>
<th>LTP</th>
<th>EIN</th>
<th>NAME OF RPE IN WHICH TB IS OPERATED</th>
<th>TB GENERAL DESCRIPTION</th>
<th>TB TYPE</th>
<th>DIRECTLY OR INDIRECTLY ENGAGED BY THIS RPE?</th>
<th>LINE 20Z - QBI</th>
<th>LINE 20AA - Section 199A W-2 WAGES</th>
<th>LINE 20AB - UBIA</th>
<th>LINE 20AC - QUALIFIED REIT DIVIDENDS</th>
<th>LINE 20AD - PTP INCOME /(LOSS)</th>
<th>NET §1231 GAIN /(LOSS)</th>
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<tbody>
<tr>
<td>LTP</td>
<td>12-345xxx</td>
<td>Gourmet Grocery QTB</td>
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<td>MTP</td>
<td>10-111xxx</td>
<td>Food Truck QTB</td>
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<td>300</td>
<td>25</td>
<td>10</td>
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<tr>
<td>UTP</td>
<td>15-161xxx</td>
<td>Restaurant QTB</td>
<td>DIRECTLY</td>
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<td>95</td>
<td>40</td>
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<td>1100</td>
<td>130</td>
<td>70</td>
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</tbody>
</table>
Pursuant to Reg. 1.199A-4(c)(4) UTP is considered a relevant passthrough entity ("RPE") and has aggregated the following trades or businesses at its level:

<table>
<thead>
<tr>
<th>NAME OF RPE IN WHICH TB IS OPERATED</th>
<th>EIN</th>
<th>TB GENERAL DESCRIPTION</th>
<th>TB TYPE</th>
<th>DIRECTLY OR INDIRECTLY ENGAGED BY THIS RPE?</th>
<th>OTHER TB ITEMS</th>
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<td>LTP</td>
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<td>Gourmet Grocery</td>
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<td>QTB</td>
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<tr>
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<td>Restaurant</td>
<td>QTB</td>
<td>DIRECTLY CEASED</td>
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</table>

[Description of aggregated TBs and explanation of the factors met that allow the aggregation in accordance with Treas. Reg. § 1.199A-4]

Section 199A - TRADE OR BUSINESS ("TB") DETAIL

<table>
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<tr>
<th>NAME OF RPE IN WHICH TB IS OPERATED</th>
<th>EIN</th>
<th>TB GENERAL DESCRIPTION</th>
<th>TB TYPE</th>
<th>DIRECTLY OR INDIRECTLY ENGAGED BY THIS RPE?</th>
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<th>LINE 20AA - SECTION 199A W-2 WAGES</th>
<th>LINE 20AB - UBIA</th>
<th>LINE 20AC - QUALIFIED REIT DIVIDENDS</th>
<th>LINE 20AD - PTP INCOME/(LOSS)</th>
<th>NET §1231 GAIN/(LOSS)</th>
</tr>
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<tr>
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<tr>
<td>AGGREGATED T/Bs</td>
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<td></td>
<td>1100</td>
<td>130</td>
<td>70</td>
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</tr>
</tbody>
</table>
Failure to Report

- General tax considerations
  - Generally, a partnership is required to separately state any information a partner needs to compute its tax liability
  - Form 1065 instructions require a partnership to report any information needed by a partner to file its return

- Specific Section 199A rules
  - Treas. Reg. § 1.199A-6(b)(3)(iii): "If an RPE fails to separately identify or report on the Schedule K-1 (or any attachments thereto) issued to an owner an item described in paragraph (b)(3)(i) of this Section, the owner's share (and the share of any upper-tier indirect owner) of each unreported item of positive QBI, W-2 wages, or UBIA of qualified property attributable to trades or businesses engaged in by that RPE will be presumed to be zero"
  - Preamble to final Section 199A regulations: "Guidance on the application of penalties is beyond the scope of these regulations"

- RPEs generally have fiduciary duties to their partners
Section 163(j) Reporting
Section 163(j) Overview

• The TCJA imposes a new limitation on deductibility of business interest expense (BIE):
  • Limited to the sum of:
    ➢ (1) 30% of adjusted taxable income (ATI),
    ➢ (2) business interest income (BII), and
    ➢ (3) floor plan financing interest for the tax year

• Disallowed BIE is carried forward

• Section 163(j) limitation is applied at the partnership level AND partner level
  • Partnership applies Section 163(j) without regard to partner-level ATI, business interest expense/income, etc.
  • Partner determines ATI without regard to partnership income, gain, loss, or deduction, subject to exceptions

• Certain taxpayers are excepted (e.g., small business taxpayers and electing real property businesses)
Section 163(j) Reporting

- Schedule K-1 line items
  - Line 13K – Excess business interest expense (EBIE)
  - Line 20AE – Excess taxable income (ETI)
  - Line 20AF – Excess business interest income (EBII)

- Detailed (whitepaper) disclosures
  - Gross receipts for small business testing
  - Other items impacting a partner's ATI:
    - Section 704(c) remedial items
    - Section 743(b) items
    - Section 704(c)(1)(c) items
  - Exempt entity reporting
    - BIE, BII, and items comprising ATI for partner-level Section 163(j) calculation
  - Guaranteed payments for the use of capital
  - Information related to an electing partnership (e.g., electing real property trade or business)
    - Allocable share of asset basis attributable to non-excepted and excepted trades or businesses for interest tracing rules
  - Sale of partnership interest
    - Historic DD&A allocation
11-Step Process

- Proposed regulations contain an 11-step process for determining the extent to which a partner's distributive share of partnership items consist of:
  - BIE for which a deduction is allowed under Section 163(j)
  - BIE for which a deduction is not allowed under Section 163(j) (i.e., EBIE)
  - ETI of the partnership
  - EBII of the partnership

- The 11-step process is a mechanical calculation that applies to all partnerships subject to Section 163(j)

- If pro rata allocations, no special or regulatory allocations and no Section 704(c) sale gain/loss, do the 11 steps and a "shortcut" approach lead to different results?
EBIE, ETI, and BII in Tiered Partnerships

- **EBIE**
  - Only "freed" upon allocation of ETI or EBII from the same partnership (or upon a sale of all or substantially all of the partner's interest in the partnership)
  - Query whether it impacts direct partners only?

- **ETI and EBII**
  - ETI increases partner-level ATI
  - EBII increase partner-level BII
  - May impact Section 163(j) calculation for direct and indirect partners
Small Business Exception: Reporting by ALL Partnerships

• Small business exception
  • The Section 163(j) limitation does not apply to a taxpayer (other than a tax shelter) if the taxpayer's average annual gross receipts for the three taxable years preceding the current taxable year do not exceed $25 million

• $25 million dollar gross receipts test
  • Gross receipts of separate tax entities may be combined
  • Section 448(c)(2)'s aggregation rules allow for upwards, downwards and "sideways" attribution or a combination thereof
    ➢Generally applies where there is a more than 50% ownership interest
    ➢May apply in other situations
  • Where a partner is determining its eligibility for the small business exception and Section's 448(c) aggregation rules do not apply, the partner must include a share of partnership-level gross receipts to determine its own eligibility (this results in upward attribution only)
  • Thus, partners, including minority partners, need to know their share of partnership-level gross receipts in order to determine their partner-level eligibility
Small Business Exception: Reporting by a Small Business Partnership

- Prop. Reg. § 1.163(j)-6(m)(1) provides that a partner or S corporation includes items of income, gain, loss, or deduction from the exempt entity (e.g., small business partnership) when calculating its ATI and also includes its share of BII from the entity.
  
  ➢ See also Prop. Reg. § 1.163(j)-6(o), Ex. (6) and Ex. (7)

- The Form 8990 instructions: "Ownership of pass-through entities not subject to the Section 163(j) limitation. If you are subject to the Section 163(j) limitation and are an owner of a pass-through entity that is not subject to the Section 163(j) limitation, you must include your share of the pass-through business interest expense, adjusted taxable income, and business interest income on lines 1, 13, and 23, respectively. You must request the pass-through entity to separately state, in sufficient detail, the items necessary to figure these amounts."

- Should a small business partnership provide a partner's "share" of BIE, ATI and BII on the K-1s?
Corporate Partners

• Investment interest expense is not subject to Section 163(j) limitation at the partnership level; it is allocated out to partners for deduction

• Proposed regulations:
  • Clarify that all interest expense paid or accrued by a C corporation on debt of such C corporation is business interest
  • Clarify that all interest on debt held by a C corporation that is includible in gross income of such C corporation is business interest income
  • Address C corporation partners’ distributive share of partnership investment interest income and investment interest expense: such investment income and investment expense is recharacterized as allocable to a trade or business of the C corporation partner
Section 1061
Reporting
Carried Interest Overview

• Section 1061 converts net long-term capital gain “with respect to” an applicable partnership interest (API) to short-term capital gain to the extent the gain would not qualify as net long-term capital gain if "1 year" is changed to "3 years" in Section 1222(3) and (4), notwithstanding Section 83 or any election in effect under Section 83(b).

• APIs are partnership interests that are
  ➢ directly or indirectly transferred to, or held by, a taxpayer
  ➢ in connection with the performance of substantial services by the taxpayer or a related person
  ➢ in any “applicable trade or business.”
What Gains are Recharacterized?

• Amount treated as short-term capital gain is the excess of:
  ➢ The taxpayer's net long-term capital gain with respect to the API for the taxable year over
  ➢ The taxpayer's net long-term capital gain with respect to the API for the taxable year computed by applying paragraphs (3) and (4) of Section 1222 by substituting "three years" for "one year“

• Net Impact?
  ➢ Capital gain subject to section 1061 is recharacterized as short-term capital gain.
    • Not recharacterized as ordinary income.
  ➢ Capital gain allocated to the partner from an API on the sale of an asset by the partnership.
  ➢ Capital gain on a sale of an API by a partner.
Section 1061 Reporting: Example

Line 20AH – Other Information:

Section 1061 provides that all or a portion of the net long-term capital gain of a taxpayer from assets held three years or less that is attributable to one or more applicable partnership interests is subject to potential recharacterization as short-term capital gain. The amounts reported on Line 9a of your Schedule K-1 include the following:

The amount of the net long-term capital gain (loss) reported on Line 9a from assets held for three years or less attributable to a general partner interest in [name of Fund] is: $[Amount]

Please consult your tax advisor for the proper treatment of these items on your tax return.
Questions to Consider

Section 1061 reporting starts here
Negative Tax Capital
Account Reporting
Reporting of Negative Capital Accounts

• Instructions for Form 1065 now require that “tax basis capital” must be reported for any partner whose tax basis capital account would be negative either at the beginning or end of the taxable year, regardless of the accounting method used to report the entity’s balance sheet.

• IRS FAQ provides guidance on how to compute "tax basis capital," along with a safe harbor:
  - Safe Harbor: “Partnerships may calculate a partner’s tax basis capital account by subtracting the partner’s share of partnership liabilities under [Section] 752 from the partner’s outside basis (safe harbor approach). If a partnership elects to use the safe harbor approach, the partnership must report the negative tax basis capital account information as equal to the excess, if any, of the partner’s share of partnership liabilities under [Section] 752 over the partner’s outside basis.”

• The IRS announced in Notice 2019-20 that it will waive penalties for failures to report if:
  - The Schedule K-1 is timely filed, including extensions, and
  - The partnership files with the IRS no later than 180 days after the six-month extended due date for the partnership's Form 1065 or, for a calendar year partnership, no later than March 15, 2020, a schedule setting forth certain partner information in accordance with guidance posted by the IRS.
Line 20AH – Other Information:

Your beginning tax basis capital account is: $[Amount]

Your ending tax basis capital account is: $[Amount]

The amounts reported above represent your tax basis capital account. These amounts do not include your allocable share of partnership liabilities and are not intended to represent your tax basis in your partnership interest. Please consult your tax advisor.
Questions?