PARTNERSHIPS

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Wipfli Tax Update 2021

- Topics to be covered:
  - BBA Partnerships – Electing Out, Amending & Superseding Returns
  - Qualified Nonrecourse Debt (QNR)
  - Tax Basis Capital Reporting Refresher
  - Self-Employment Income for LLC Members

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BBA Partnerships – Electing Out, Amending, and Superseding Returns

- What is a BBA partnership?
  - All partnerships and LLCs taxed as partnerships, are BBA partnerships, unless they are an *eligible partnership* and have made an *annual election out* of the BBA rules on a timely-filed Form 1065
- What are the implications of being a BBA partnership?
  - IRS auditors can assess and collect any understated tax at the partnership level, rather than at the partner level (easier collection = increasing likelihood of being audited?)
  - With extremely limited exceptions, cannot file amended tax returns
  - Are subject to a complicated (and potentially detrimental) process for correcting prior year tax return errors known as the Administrative Adjustment Request (AAR) method

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BBA Partnerships – Electing Out, Amending, and Superseding Returns

- What is an eligible partnership?
  - A partnership with 100 or fewer partners
    - Based on the number of K-1's issued by the partnership that year
    - Must "look-thru" an S corporation partner and count K-1's they issue to their shareholders
  - All partners must be one of the following:
    - Individual
    - C or S corporation (including tax-exempt, nonstock corporation)
    - Foreign entity that would be C corporation if it were a domestic entity
    - Estate of a deceased partner
  - No partner can be a partnership, LLC, trust, DRE (e.g., a SMLLC or QSUB), or nominee

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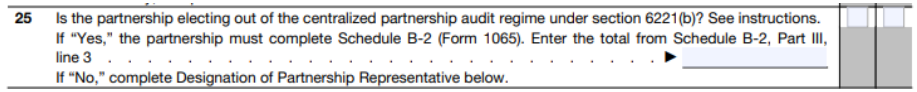
BBA Partnerships – Electing Out, Amending, & Superseding Returns

- Electing out of the BBA regime
  - Annual election, made on a timely-filed (including extension) return
  - Requires a box on Form 1065, Schedule B to be checked



25	Is the partnership electing out of the centralized partnership audit regime under section 6221(b)? See instructions. If "Yes," the partnership must complete Schedule B-2 (Form 1065). Enter the total from Schedule B-2, Part III, line 3 ▶	
	If "No," complete Designation of Partnership Representative below.	

  - Requires a disclosure on Form 1065, Schedule B-2, regarding each person that was a partner at any time during the year

SCHEDULE B-2 (Form 1065) (December 2018) Department of the Treasury Internal Revenue Service	**Election Out of the Centralized Partnership Audit Regime** ▶ Attach to Form 1065 or Form 1066. ▶ Go to *www.irs.gov/Form1065* for instructions and the latest information.

  - Requires the partnership to provide an annual statement to its partners within 30 days of making the election, notifying the partners that the election out has been made
    - Axcess includes this notification on each partner's K-1, in the form of a footnote
  - WARNING! Need to confirm eligibility each year – because partners can change from year to year or partners can be added (e.g., due to sale, gifting, transfer to another party). Don't automatically assume they are eligible and elect out just because they did so last year.

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BBA Partnerships – Electing Out, Amending & Superseding Returns

- Exceptions to amended return prohibition – THESE ARE THE **ONLY** ONES!
  - Rev. Proc. 2020-23
    - Amend 2018 and 2019 returns
    - For CARES Act changes, like QIP qualifying for 15-year life & bonus (and other adjustments)
    - *Was due by 9/30/20*
  - Rev. Proc 2021-29
    - Amend 2018-2020 returns
    - For taxpayers that made the RPToB election to avoid the Sec. 163(j) limitation and had residential real property placed in service prior to 1/1/18 that they depreciated using an ADS life of 40 years instead of 30 years (and other adjustments)
    - *Was due by 10/15/21*
  - *May be more in the future if there are major law changes, esp. if there are retroactive impacts*

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BBA Partnerships – Electing Out, Amending & Superseding Returns

- Superseding return strategy
  - What is a superseding return?
    - An *amended* return *corrects* an originally filed return
    - A *superseding* return is treated as *replacing* a partner's original return
    - BBA partnerships are not allowed to file amended returns, but can file superseding ones
  - What is the strategy?
    - Extend the partnership return (consider doing for all BBA partnerships)
    - File the original return (timely or prior to the extended due date)
    - File a superseding return prior to the extended due date
    - This works for federal tax purposes, but consider state tax implications (state may not allow a superseding return, but may follow BBA rules and not allow amended return either?)

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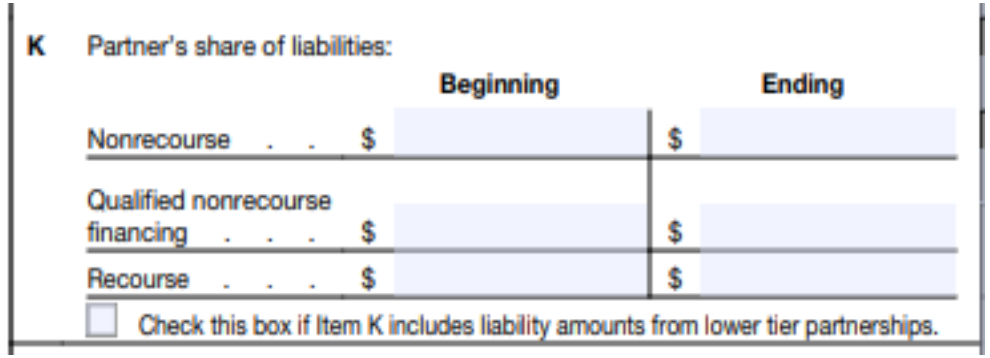
Qualified Nonrecourse Debt (QNR)

- Qualified nonrecourse debt is the best kind of debt
  - Nonrecourse
    - Partner is not economically at risk
    - Included in partner's tax basis, but not their amount at-risk (Don't forget about at-risk limitation: like basis, at-risk determines current deductibility of losses, but it also determines recapture of losses deducted in prior years)
  - Qualified Nonrecourse
    - Partner is not economically at risk
    - Included in partner's tax basis and amount at risk
  - Recourse
    - Partner is economically at risk
    - Included in partner's tax basis and amount at risk



K	Partner's share of liabilities:	Beginning	Ending
	Nonrecourse . . $	$	
	Qualified nonrecourse financing . . . $	$	
	Recourse . . . $	$	

☐ Check this box if Item K includes liability amounts from lower tier partnerships.

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Qualified Nonrecourse Debt (QNR)

- Requirements for QNR debt
  - Must be secured only by real property and incidental personal property
    - Incidental – not defined in regulations, but under Sec. 1031, personal property is incidental if its value does not exceed 15% of the overall value of the larger property
    - Collateral that is not real property or incidental personal property can be disregarded if its FMV < 10% of total FMV of all property securing the debt (determined on date loan is issued)
  - Must be borrowed in connection with the activity of holding real property
    - Activity of holding real property - not defined in regulations, but there is a CCA
      - Business activity consisting solely of acquiring existing hotels, renovating, installing personal property, maintaining the premises, and leasing to another party qualifies as the activity of holding real property
      - Engaging in the hotel's day-to-day operations does not qualify as the activity of holding real property

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Qualified Nonrecourse Debt (QNR)

- Must be made by an entity actively and regularly engaged in the business of lending money or must be made or guaranteed by a federal, state, or local government
  - Common examples – bank, other financial institution, pension plans, and municipalities
- Must not be made by the seller of the property securing the debt or a person related to the seller
- Must not be made by a broker or other person who received a fee with respect to the owner's investment in the at-risk activity
- Must not be from a related person, except where the loan is commercially reasonable
- No person can be personally liable for repayment of the loan
  - Debt will be recourse to the guaranteeing partner
  - Ignore these guarantees: completion, bad-boy carve outs, bottom dollar, or certain indemnified guarantees

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Qualified Nonrecourse Debt (QNR)

- Loan cannot be convertible debt
- Correct classification of debt
  - Knowledge required
    - Tax advisors are generally aware of the first requirement for QNR debt, but not always aware of the other requirements
    - Tax advisors do not always understand the different types of guarantees and indemnifications
  - Due diligence required
    - Must obtain copies of debt instruments, guarantees and indemnifications for analysis
    - Must annually inquire regarding any changes in guarantees, collateral, etc. for all partnership debt (if using Wipfli's Tax Information Request form for partnerships, this issue is addressed)
    - What if classified wrong in prior years? "There are new partnership debt regulations, and the IRS is focusing more on partnership audits – its worth revisiting" = revenue generating project

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Tax Basis Capital Reporting Refresher

- Using tax basis capital – transactional approach to complete Schedule M-2 and Schedule K-1, Item L is MANDATORY
  - Per IRS, certain small partnerships are not technically required to complete Schedule M-2 or Schedule K-1, Item L
  - However, Wipfli policy is that these schedules be completed, even if not required by IRS
  - Penalties
    - Hefty penalties apply for taxpayers not using tax basis capital reporting
    - For the 2020 tax year, there was some limited, transitional penalty relief for not using tax basis capital reporting – but that relief does *not* apply for 2021 tax year
  - The IRS wants tax basis capital reporting because it makes it easier to identify situations where K-1 losses may not be currently deductible, or distributions may be taxable
    - Preparers need to recognize these situations and should add warning sentence as K-1 footnote

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Tax Basis Capital Reporting Refresher

- Required adjustments
  - On *2020* tax returns, additional work was required to convert the Sch. M-2 and Sch. K-1, Item L beginning amounts to the tax basis method – transactional approach amounts
  - On *2021* tax returns, those adjustments will not be required (assuming 2020 return was prepared correctly – if not: amend/AAR/catch up in 2021)
- Tax basis method – transactional approach
  - Increased by
    - Tax basis of cash and property capital contributions (net of associated liabilities)
    - Allocations of taxable income and gain (including negative Sec. 734(b) depreciation/amortization expense – negative depreciation expense is income)
    - Allocations of tax-exempt income and gain

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Tax Basis Capital Reporting Refresher

- Tax basis method – transactional approach (continued)
  - Decreased by
    - Tax basis of cash and property distributions (net of associated liabilities)
    - Allocations of taxable loss and deduction (including Sec. 734(b) depreciation/amortization expense)
    - Allocations of non-deductible, non-capitalizable loss and deduction
  - Not impacted by
    - Sec. 734(b) step-ups or step-downs
    - Partner-specific adjustments such as Sec. 743(b) step-ups or step-downs and the related Sec. 743(b) depreciation/amortization
    - Guaranteed payments received by a partner for services or the use of capital

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Tax Basis Capital Reporting Refresher

- Additional required disclosures on Sch. K-1
  - Partner's net remaining Sec. 743(b) step-up or step-down – K-1, Box 20, Line AH
  - Positive Sec. 743(b) adjustments for depreciation/amortization/gain – Sch. K-1, Box 11F
  - Negative Sec. 743(b) adjustments for depreciation/amortization/loss – Sch. K-1, Box 13V
- Reporting a transfer of capital
  - Sch. M-2 and Sch. K-1, Item L – Other increase/Other decrease (NOT Contribution/Distribution)
  - Applicable to sale, exchange, gift, or bequest
- Reporting a liquidating redemption of a partner's interest
  - Sch. M-2, and Sch. K-1, Item L – Other increase/Other decrease
  - Applicable only to liquidating redemption , a non-liquidating redemption (partial redemption) is reported as a distribution

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Self-Employment Income for LLC Members

- Self-employment income in a partnership
  - *General partners* are subject to self-employment tax on their allocated share of partnership income and on their guaranteed payments for services
  - *Limited partners* are not subject to self-employment tax on their allocated share of partnership income, only on their guaranteed payments for services
- Self-employment income in an LLC
  - There is no guidance specific to an LLC, just proposed regulations that were issued in 1997 and never withdrawn, modified, or finalized
  - Is an LLC member treated as a *general partner* or a *limited partner* for self-employment tax purposes?
    - Like a *limited* partner, an LLC member has limited liability for LLC debts
    - Like a *general* partner, an LLC member can participate in the management of the LLC and enter into contracts on behalf of the LLC

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Self-Employment Income for LLC Members

- Why is this a “hot issue” now?
  - On May of 2021, the IRS Office for Passthroughs and Special Industries confirmed that the IRS is focusing on self-employment for LLC members during on-going IRS audits
  - With the BBA partnership audit rules in full effect, it is much easier for the IRS to audit partnerships, so they are much more likely to discover understated self-employment income and then pursue collection of the resulting tax from the appropriate partner(s)
- Why do the 1997 proposed regulations matter?
  - Since the regulations are still only proposed, they are not binding on the IRS or taxpayers
  - However, they still provide insight into the IRS’ thinking with respect to this issue and where agents are likely to challenge taxpayer in an audit
  - Also, the IRS has indicated that they would not challenge taxpayers who follow the proposed regs

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Self-Employment Income for LLC Members

- Under the proposed regs, an LLC member will be generally be treated as a limited partner *unless* the member meets one of these tests:
  - Has personal liability for debts or claims against the LLC by reason of being a member (guarantees of debt are disregarded for this purpose)
  - Has authority under the LLC's state of formation to contract on behalf of the LLC
    - Member-managed LLC – all the members have that authority
    - Manager-managed LLC – only the manager has that authority
  - Participates in the LLC's trade or business for more than 500 hours during the LLC's taxable year
    - Similar to the requirements under the passive activity rules, detailed logs should be kept by the partner to substantiate hours spent (to show they are < 500 hours)
  - Is a service member in an LLC that is a service partnership, and the member provides more than a de minimis amount of service to the partnership

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Self-Employment Income for LLC Members

- The 1997 proposed regs contain two exceptions for LLC members who meet one or more of the above tests, so they can still avoid SE tax
  - Single-class-of-interest exception
    - The member holds a single class of LLC interest
    - The member failed to be a limited partner *solely* because they provided more than 500 hours of service to the partnership
    - Substantial, continuing interests of the same class of LLC interests are held by one or more other members who do qualify as limited partners under the proposed regs
      - Under a safe harbor, interests held by the other members are deemed to be substantial if they constitute 20% of the total interests in that class
    - The member's rights and obligations with respect to their class of interest are identical to the rights and obligations of the specific class held by the other LLC members who do qualify as limited partners under the proposed regs

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Self-Employment Income for LLC Members

- The 1997 proposed regs contain two exceptions for LLC members who meet one or more of the above tests, so they can still avoid SE tax (cont'd)
  - Two-classes-of-interest exception
    - The member holds two separate classes of LLC interest
    - The member failed to be a limited partner under *any* of the four tests listed above
    - The member holds a class of interest that meets the substantiality test described above
    - This exception acknowledges that a member can bifurcate their interest in the LLC by holding two separate classes of interests –
      - One class where the member is a manager and takes on a role similar to that of a general partner
      - Another class where the member is in a more passive role, akin to a limited partner

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