New Partnership Tax Basis Reporting Requirements

By Stephanie Morgan, CPA, MBA

In January, the IRS published a second early draft of the 2020 instructions for Form 1065. The original early draft was released on October 21, 2020 with a 30-day request for comment that was to end on November 20 and with the intention of releasing final instructions in December. At the time of this writing, final instructions have not been published.

Under the most recent draft instructions for tax year 2020, all partnerships must report each partner's tax basis capital using the transactional method. Partnerships that have not previously used the tax basis method to maintain capital accounts may determine each partner's beginning tax basis capital account balance using one of three methods:

- the modified outside basis method,
- the modified previously taxed capital method, or
- the Sec. 704(b) method.

This article discusses how the reporting requirements for partners' capital accounts have changed over recent years and walks through each method for recalculating beginning tax basis capital.

Background

Beginning in tax year 2018, the instructions for Form 1065 included a new tax basis capital reporting requirement for certain partnerships stating:

"If a partnership reports other than tax basis capital accounts to its partners on Schedule K-1 in Item L, and tax basis capital, if reported on any partner's Schedule K-1 at the beginning or end of the tax year would be negative, the partnership must report on Line 20 of Schedule K-1, using code AH, such partner's beginning and ending shares of tax basis capital.[1]"

The 2018 instructions defined tax basis capital as:
1.) the amount of cash plus the tax basis of property contributed to a partnership by a partner minus the amount of cash plus the tax basis of property distributed to a partner by the partnership, net of any liabilities assumed or taken subject to, in connection with such contribution or distribution; plus
2.) the partner's cumulative share of partnership taxable income and tax-exempt income; minus
3.) the partner's cumulative share of taxable loss and nondeductible, noncapital expenditures.[2]

Draft instructions to the 2019 Form 1065 included the new tax-basis-only reporting requirement, but for all partnerships regardless of the balance, negative or otherwise, of the individual partner's capital accounts. Due to concern that partnerships would not have adequate time to comply with the new reporting requirements, the IRS issued Notice 2019-66 to defer implementation to tax year 2020. Additionally, notice 2019-66 indicated that additional guidance on the definition of partner tax basis capital would be forthcoming.

On June 5, 2020, the IRS issued Notice 2020-43, in which they sought public comment on two methods for maintaining tax basis capital accounts for use on Schedule K-1 if the tax basis method was not previously used. They are the modified outside basis method and the modified previously taxed capital method.

In late October 2020, the IRS released drafts of the 2020 instructions for Form 1065 and simultaneously published a news release in which they stated: "The IRS and the Treasury Department received numerous comments from taxpayers requesting that the tax basis method approach be retained. At the same time, the IRS did not receive practical alternative approaches to partner capital account reporting."

They went on to explain that by putting all tax filers on the same method, they expect ultimately to reduce the likelihood of compliant returns undergoing examination.[3] As such, the draft instructions follow pretty closely to the provisions laid out in Notice 2020-43 with a few additions.

The draft instructions require the use of the transactional approach to calculate the partners' tax basis method capital accounts balances. Going forward, all partnerships will be required to use the transactional tax basis method to report partner's capital accounts on Schedule K-1. For one year only, in 2020, partnerships that have not historically used the tax basis method can refigure a partner's beginning capital account balance using either the modified outside basis method, the modified previously taxed capital method, or the Sec. 704(b) method.

The instructions also describe certain disclosure requirements stating: "You must also attach a statement to the partners' Schedules K-1 indicating the method used to determine each partner's beginning capital account. If the modified previously taxed capital method is used, the statement must also include the method used to determine the partnership's net liquidity value (fair market value, section 704(b) book value, etc.)."[4]

Transactional Method

The transactional method is really a general rule put forth by the IRS that requires a partnership to consistently maintain tax basis capital accounts by applying the provisions of the Internal Revenue Code to each item of contribution and distribution between a

Going forward, all partnerships will be required to use the transactional tax basis method to report partner's capital accounts on Schedule K-1.

partner and a partnership, as well as all allocated items of income, gain, loss and deduction. The instructions describe it as "a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of sections 705, 722, 733 and 742, and by reporting the amount on the line for other increase (decrease)."

The instructions then describe the way to complete various lines of Item L depending on whether the organization previously used the tax basis method or not. If it used the tax basis method, then things continue to operate pretty normally and the instructions provide some guidance on how to report changes in partnership interest that occur during the year.

If, for some reason, the partnership reported a negative ending tax basis capital account to any partner on the 2019 tax return, and a different amount is reported for the beginning tax basis capital account on the 2020 tax return, then an explanation is required.

Capital contributed during the year will consist of the amount of cash plus the adjusted tax basis of all property contributed to the partnership during the tax year. The basis in any such property should be reduced for the amount of liabilities assumed by the partnership. Note that this amount could be negative. The line for current year net income (loss) obviously reports each partner's distributive share of taxable partnership income, gain and loss.

The line for other increase (decrease) can be used to report all other items that affected each partner's capital account for the year. An explanatory statement for each adjustment must be attached. The instructions provide several examples, including the partner's share of excess depletion and Section 743(b) adjustments.

Here the IRS notes that Section 743(b) basis adjustments are not taken into account under the tax basis method. Therefore, if Section 743(b) adjustments were included in the ending capital account balance reported on the 2019 return, those amounts, whether positive or negative, should be removed from each partner's capital account for the 2020 tax year and reported as another increase or decrease.

Withdrawals and distributions will consist of the amount of cash received by the partner plus the adjusted tax basis of any property received from the partnership reduced by any liabilities assumed by the partner. Again, this number might be negative. The ending capital account will, as expected, be the sum of the amounts from all lines in item L.

Modified Outside Basis Method

Using the modified outside basis method, a partner's tax basis capital account is essentially equal to its outside basis in the partnership interest less the partner's share of partnership liabilities and Section 743(b) adjustments. The instructions describe the method in the following terms:

> **"The amount to report as a partner's beginning capital account under the modified outside basis method is equal to the partner's adjusted tax basis in its partnership interest as determined under the principles and provisions of subchapter K including, for example, sections 705, 722, 733 and 742; and subtracting from that basis (1) the partner's share of partnership liabilities under section 752 and (2) the sum of partner's section 743(b) adjustments (that is, net section 743(b) adjustments). For purposes of establishing a partner's beginning capital account, you may rely on the adjusted tax basis information provided by your partners."[5]**

While this method is simple enough on paper, it may prove more difficult in application for partnerships, which have not historically kept this data in their records. However, the draft instructions do state "you may rely on the adjusted tax basis information provided by your partners."

Modified Previously Taxed Capital Method

On the other end of the spectrum is the vastly more complex, modified previously taxed capital method. Though more cumbersome, it might be a necessary evil for those partnerships that do not have access to large amounts of historical data. Under this method, a partner's capital account balance is calculated by applying modified principles to the rules described in the regulations for computing a partner's share of previously taxed capital.

Section 1.743-1(d)(1) provides that generally a partner's share of the adjusted basis of partnership property is equal to the sum of the partner's interest in the partnership's previously taxed capital, plus the partner's share of partnership liabilities.

The regulations define previously taxed capital as 1.) the amount of cash that the partner would receive on a hypothetical fully taxable liquidation of the partnership at fair market value, plus 2.) the amount of tax loss that would be allocated to the partner from the hypothetical transaction, less 3.) the amount of tax gain that would be allocated to the partner from the hypothetical transaction.[6]

One of the modifications made to the regulations in the instructions is the allowance for substituting net liquidity value for the assets' fair market value in the hypothetical transaction, stating "assets bases as determined under Section 704(b); as determined for financial accounting purposes; or on the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate."[7]

The other modification is that when calculating the amount of gain or loss that would be allocated to each partner in the hypothetical liquidation, all liabilities are treated as non-recourse. In Notice 2020-43, the IRS explains that this was done to "avoid the burden of having to characterize the underlying debt and to simplify the computation."

Section 704(b) Method

Generally, Section 704(b) capital account balances reflect each partner's share of the economic interest in the entity. The instructions describe the method as follows:

> **"The amount to report as a partner's beginning capital account under the Section 704(b) method is equal to the partner's Section 704(b) capital account, minus the partner's share of Section 704(c) built-in gain in the partnership's assets, plus the partner's share of Section 704(c) built-in loss in the partnership's assets."**

It is important to note here that Section 743(b) basis adjustments are not taken into account when calculating the partner's basis under this method. The instructions further provide that:

> **"Property contributed to a partnership is Section 704(c) property if, at the time of the contribution, its fair market value differs from its adjusted tax basis. Section 704(c) property also includes property with differences resulting from revaluations (reverse section 704(c) allocations). For more information, see Sections 704(b) and 704(c) and Regulations sections 1.704-1 through 1.704-3."**

What's Next?

We continue to await a final version of the instructions and must stay tuned for further developments. Some comfort is provided by the IRS granting relief to partnerships for certain penalties due to incorrect reporting of partner beginning capital account balances on the partner's 2020 K-1 forms.

Notice 2021-13 grants relief for penalties under Code Sec. 6698, Code Sec. 6721 or Code Sec. 6722 if the partnership can show that it took "ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using any one of the following methods, as outlined in the instructions: the tax basis method, modified outside basis method, modified previously taxed capital method, or section 704(b) method."[8]

Relief provided by the notice is in addition to the reasonable cause exception to penalties; however, a partnership that fails to timely file a 2020 Form 1065 or omits a partner's beginning capital account balance on the Schedule K-1 will not be eligible for relief under the notice.

ABOUT THE AUTHOR: Stephanie Morgan, CPA, MBA, is a Manager in the Business Tax Services Group of RubinBrown LLP. She can be reached at Stephanie.Morgan@RubinBrown.com.

FOOTNOTES

1 2018 Instructions for Form 1065
2 2018 Instructions for Form 1065
3 IRS News Release – IRS - 2020-240, October 22, 2020, IRS Releases Draft Form 1065 instructions on partner tax basis capital reporting
4 Draft 2020 Instructions for Form 1065
5 Draft 2020 Instructions for Form 1065
6 1.743-1(d)(1)
7 Draft 2020 Instructions for Form 1065
8 Notice 2021-13