Overview of Partnership Accounting and New Tax Return Reporting

Houston CPA Society 2020 Tax Expo

January 7, 2020

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Summary

- New Reporting Requirements
- Basics of Partnership Accounting

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IRS Publications

- New Form 1065
- New Schedule K-1
- Tax Quotes from the IRS*
  - "Taxes are what we pay for civilized society." — Oliver Wendell Holmes, Jr., U.S. Supreme Court Justice
  - "I am proud to be paying taxes in the United States. The only thing is – I could be just as proud for half the money." — Arthur Godfrey, entertainer
  - "Taxation with representation ain't so hot either." — Gerald Barzan, humorist
  - "The hardest thing in the world to understand is the income tax." — Albert Einstein, physicist

*These quotes reflect the opinions of their authors; their inclusion here is not an official IRS [or CJMH] endorsement of the sentiments expressed. https://www.irs.gov/newsroom/tax-quotes

Form 1065 U.S. Return of Partnership Income

- Schedule B
  - Question 27. Foreign partners recognizing gain or loss under Section[1] 864(c)(8) transferring or receiving a distribution related to a partner interest.
  - Questions 28. Transfers between partnership and its partners subject to disclosure under Treas. Reg. 1.707-8 (disguised sales).

1. All "Section" or "Code" references are to the Internal Revenue Code of 1986, as amended.

Schedule K-1 (Form 1065)

- Part II
  - Question E Report SSN or TIN of beneficial owner of a disregarded entity ("DE").
  - Question F Report name and address of beneficial owner of DE.
  - Question H-2 Report DE's TIN and name.

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Schedule K-1 (Form 1065)
Basics of Partnership Accounting

- Outside (Tax) Basis – Each partner's basis in their partnership interest
  - Cannot be less than zero
  - Calculated as:

+ cash and tax basis of property and cash contributed to the partnership;
+ partner's share of allocated partnership income;
- partner's share of allocated partnership loss;
- cash and tax basis of property distributed;
+ partner's share of partnership liabilities; and
- partnership's share of partner liabilities.

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Schedule K-1 (Form 1065)
Basics of Partnership Accounting

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Schedule K-1 (Form 1065)
Reporting Negative Capital Accounts

- In 2018, the IRS began ***requiring*** partnerships to report negative tax basis capital account balances (Form 1065, Schedule K-1, Item L, line 20 code AH)

L Partner's capital account analysis:

Beginning capital account	$
Capital contributed during the year .	$
Current year increase (decrease) . .	$
Withdrawals & distributions . . .	$ ( )
Ending capital account	$

☐ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

If a partnership reports other than tax basis capital accounts to its partners on Schedule K-1 in Item L (that is, GAAP, 704(b) book, or other), 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. This is in addition to the required reporting in Item L of Schedule K-1.

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Schedule K-1 (Form 1065)
New 2019 Draft Schedule K-1
Part II Question L

L **Partner's Capital Account Analysis**

	Tax Basis Capital
Beginning capital account . . .	$
Capital contributed during the year . .	$
Current year net income (loss) . . .	$
Other increase (decrease) (attach explanation)	$
Withdrawals & distributions . . .	$ ( )
Ending capital account	$

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Schedule K-1 (Form 1065)
Exceptions to Reporting Negative Capital Accounts

- Satisfy all four conditions in Question 4 on Schedule B to Form 1065
  - Total receipts less than $250,000
  - Total assets at year end less than $1 million
  - Schedules K-1 filed with return and given to partners timely
  - Not required to file Schedule M-3
- 2018 Temporary Relief
  - Schedules K-1 filed with return and given to partners timely
  - Within one year of original due date, attach schedule:
    - "Filed Under Notice 2019-20"
    - Identify K-1's, partnership, and partners
    - Amount of partners' tax basis capital account amounts at beginning and end of year

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Schedule K-1 (Form 1065) Penalties for Not Reporting Negative Capital Accounts

- IRC Section 6722 – failure to furnish correct payee statements
- IRC Section 6698 – failure to file partnership return
- IRC Section 6038 (b) and (c) – failure to furnish information with respect to certain partnerships
- "any other section of the Code for filing or furnishing Schedules K-1 or other forms or statements"

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Special Provisions

- IRC Section 704(c) Built-In Gain or Loss
- Admission of New Partner to the Partnership
- Exit of Partners (Death, Retirement, Sale or Other Transfer)
- Allocations of Partnership Debt
- Other Considerations

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Schedule K-1 (Form 1065) Admission of New Partner to the Partnership

- Reporting
- 704(c) built-in gain or loss
- Keep appreciation with partners who earned the appreciation
- Look to partnership agreement
  - Does it require 704(b) revaluation of assets?
  - Does it determine appraisal methods?
- May also be mandatory adjustments under 704(c) due to "substantial built in loss"

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Schedule K-1 (Form 1065) Section 704(c) Built-In Gain or Loss

- Fair market value of property contributed to partnership does not equal the contributing partner's adjusted tax basis
- Subsequent gain or loss on that property is allocated to the contributing partner
- Allocation of depreciation, depletion, gain or loss takes into consideration built-in gain or loss
- No shifting of gain or loss from partners through the partnership

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Schedule K-1 (Form 1065)
2018 Reporting of Built-In Gain or Loss

Item M. Did the Partner Contribute Property With a Built-in Gain or Loss?

Check the appropriate box to indicate whether the partner contributed property with a built-in gain or loss during the tax year. If the "Yes" box is checked, attach a statement that contains the following information.

- A description of each property the partner contributed.
- The date the property was contributed.
- The amount of the property's built-in gain or loss.

M Did the partner contribute property with a built-in gain or loss?

☐ **Yes** ☐ **No**

If "Yes," attach statement (see instructions)

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Schedule K-1 (Form 1065)
2019 Draft K-1 Reporting Built-In Gain or Loss (also Part III Line AA)

Part II Question N

N Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)

Beginning . . . . $

Ending . . . . $

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Built-In Gain or Loss in the Partnership Agreement

- How to handle 704(c) is often addressed in the partnership agreement
  - May give wide discretion to general partner or manager
  - May fix which method to use:
    - Traditional
    - Traditional with curative
    - Remedial

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704(c) Traditional Method

A and B Form a 50/50 Partnership		
	704(b) Book Value	Tax Basis
A contributes depreciable property 10 yr. life	$10,000	$4,000
B contributes cash	$10,000	$10,000

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704(c) Traditional Method

- Allocation of depreciation over 10 years (tax depreciation is $400 per year $4,000 tax basis ÷ 10)

Revenue equals operating expenses	704(b) Book Depreciation	Tax Depreciation
A	500	
B	500	400

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704(c) Traditional Method

- End of year book value of depreciable property is $9,000 ($10,000 less the $1,000 book depreciation deduction) and the adjusted tax basis is $3,600 ($4,000 less the $400 tax depreciation deduction). A's built in gain with respect to the property decreases to $5,400 ($9,000 book value less $3,600 adjusted tax basis). Also, at the end of AB's first year, A has a $9,500 book capital and a $4,000 tax basis in A's partnership interest. B, the non-contributing partner, has a $9,500 book capital account and a $9,600 adjusted tax basis in B's partnership interest due to being allocated all of the tax depreciation from A's contributed asset.

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704(c) Traditional Method
Sale of the Property

- If AB sells the property at the beginning of AB's second year for $9,000, AB realizes tax gain of $5,400 ($9,000, the amount realized, less the adjusted tax basis of $3,600). The entire $5,400 gain must be allocated to A because the property A contributed has that much built-in gain remaining. If AB sells the property at the beginning of AB's second year for $10,000, AB realizes tax gain of $6,400 ($10,000, the amount realized, less the adjusted tax basis of $3,600). Only $5,400 of gain must be allocated to A to account for A's built-in gain. The remaining $1,000 of gain is allocated equally between A and B in accordance with the partnership agreement. If AB sells the property for less than the $9,000 book value, AB realizes tax gain of less than $5,400, and the entire gain must be allocated to A.

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704(c) Traditional Method
Termination and Liquidation of Partnership

- If AB sells the property at the beginning of AB's second year for $9,000, and AB engages in no other transactions that year, A will recognize a gain of $5,400, and B will recognize no income or loss. A's adjusted tax basis for A's interest in AB will then be $9,400 ($4,000, A's original tax basis, increased by the gain of $5,400). B's adjusted tax basis for B's interest in AB will be $9,600 ($10,000, B's original tax basis, less the $400 depreciation deduction in the first partnership year). If the partnership then terminates and distributes its assets ($19,000 in cash) to A and B in proportion to their capital account balance, A will recognize a capital gain of $100 ($9,500, the amount distributed to A, less $9,400, the adjusted tax basis of A's interest). B will recognize a capital loss of $100 (the excess of B's adjusted tax basis, $9,600, over the amount received, $9,500).

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Schedule K-1 (Form 1065) Exit and Entry of Partners

- Sale of partner interest
  - Must report recapture from IRC Section 751 “hot assets”
  - Withholding obligation under IRC Section 1446(f) unless non-foreign affidavit obtained
- Potential mandatory adjustments
  - Section 743 with respect to the transfer of partnership interest with a “substantial built in loss”
  - Section 734 with respect to “a substantial basis reduction”
  - Election made under Section 754 to allow an adjustment of the outside basis of a partner interest to be pushed through to the underlying partnership property
- Allocations of Partnership Debt

Schedule K-1 (Form 1065)

Question J Partner’s share of profit, loss and capital percentages BOY and EOY now includes a box to identify a change due to a sale or exchange of a partnership interest.

Schedule K-1 (Form 1065)

Part III Line 20 AB Section 751 "hot asset" gain must be reported on partners K-1.

- Section 751 gain may be triggered on the sale or exchange or distribution treated as a sale or exchange attributable to "unrealized receivables" or "inventory items that have appreciated substantially in value."

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Section 751 Hot Assets

- Unrealized Receivables Section 751(c)-generally:
  - Goods delivered or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset;
  - Services rendered or to be rendered;
  - Recapture income pursuant to Code Sections 1245, 1250 and 1254; and
  - Trademarks, tradenames, stock in DISCs and CFC's, and market discounts in bonds.

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Section 751 Hot Assets

- Inventory Items-Generally Section 751(d):
- Property of the partnership of the kind described in Code Section 1221(a)(1);
- Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in Code Section 1231; and
- Any other property held by the partnership which, if held by the selling or distributee partner, would be considered property of the type described above.

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Section 751 Hot Assets

- Inventory (cont)
  - In general, "distribution" of inventory is distinguishable from inventory items in a "sale or exchange" of a partner interest.
  - A distribution of inventory requires that the inventory "has appreciated substantially in value" in order for it to be a Hot Asset. In general, substantial appreciation means that the fair market value of the inventory exceeds 120% of the partnership's adjusted tax basis in the inventory.
  - A sale or exchange does not require substantial appreciation in the value of the inventory for the inventory to be a Hot Asset.

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Section 751 Hot Assets

- Balance Sheet of ABC Partnership:

Assets	Adjusted Basis	Fair Market Value
Cash	$30,000	$ 30,000
Inventory	30,000	39,000
Land	39,000	45,000
Total	$99,000	$114,000

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Section 751 Hot Assets-Inventory

	Total	Capital Assets	751 Assets
1/3 Partner Interest sold for	$38,000	$25,000	$13,000
Selling Partner's tax basis	33,000	23,000	10,000
Total Gain	$5,000		
Capital Gain		$2,000	
751 Ordinary Gain			$3,000

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Section 751-Hot Assets-Recapture

Balance Sheet DER Partnership		
Assets	Adjusted Basis	Fair Market Value
Cash	$30,000	$30,000
Depreciable Property (Original cost $39,000 [$9,000 accumulated depreciation])	30,000	39,000
Land	54,000	45,000
Total	$114,000	$114,000

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Section 751 Hot Assets-

	Total	Capital Assets	751 Assets
1/3 Partner Interest sold for	$38,000	$25,000	$13,000
Selling Partner's tax basis	38,000	22,000	10,000
Total Gain	$0		
Capital Loss		($3,000)	
751 Ordinary Gain			$3,000

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Section 751 Hot Asset

- Partnership must file Form 8308 Report of a Sale or Exchange of Certain Partnership Interests

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Section 1446(f) Withholding on Dispositions of Partnership Interests

- Transferee must deduct and withhold 10% of the amount realized on a disposition.
- Exception if transferor provides a non-foreign affidavit.
- Partnership must deduct and withhold distributions to transferee (if transferee fails to withhold) and file Form 8804 Annual Return for Partnership Withholding Tax (Section 1446).

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Schedule K-1 (Form 1065)

- Part III Line 11F Report Section 743(b) positive adjustments.
- Line 13V Report Section 743(b) negative adjustments.

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Section 754
Mechanics of the Election

- Section 734(a) / 743(a) – the basis of partnership property does not change upon a transfer of a partnership interest or distribution of partnership property.
- Section 734(b) / 743(b) – if a Section 754 Election is in effect, the basis of partnership property can be adjusted upon a transfer of a partnership interest or distribution of partnership property.
- The basis adjustment only applies with respect to the transferee partner, not to the other partners:
  - Treas. Reg. § 1.743-1(j)(1) - in calculating income, deduction, gain and loss, the transferee will have a special basis for the partnership properties with basis adjustments.

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Section 754
Mechanics of the Election - Basis Increase

- Section 734(b)(1) - increase the adjusted basis of partnership property by the amount of gain recognized to the distributee partner with respect to the distribution of partnership property under Section 732(a)(1).
- Special rules for a Section 732(a)(2) distribution and a Section 732(b) liquidating distribution:
  - Adjusted basis of property after distribution cannot exceed distributee partner's outside basis;
  - Increase the adjusted basis of partnership property by the "lost" basis
    - The distributee partner's proportionate share of the adjusted basis in partnership assets; and
    - The distributee partner's outside basis in the partner interest.

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Section 754
Mechanics of the Election - Basis Increase

- Section 743(b)(1) – increase the adjusted basis of partnership property by the difference between:
  - The transferor partner's outside basis in the partner interest, and
  - The transferor partner's proportionate share of the adjusted basis in partnership assets.

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Section 754
Mechanics of the Election - Basis Decrease

- Section 734(b)(2) – decrease the adjusted basis of partnership property by the amount of loss recognized to the distributee partner with respect to the distribution of partnership property under Section 732(a)(2);
  - Special rules for a Section 732(b) liquidating distribution.
- Section 743(b)(2) – decrease the adjusted basis of partnership property by the difference between:
  - The transferor partner's proportionate share of the adjusted basis in partnership assets, and
  - The transferor partner's basis in the partner interest.

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Section 754
Section 734(a) Fact Pattern

- Partner receives a distribution of cash from the partnership.
- The cash distribution is in excess of the partner's outside basis in its partnership interest.
- Partner recognizes gain on the distribution in the amount of such excess.
- Partnership steps up the basis of undistributed partnership assets by the amount of gain recognized by the partner;
  - If the distribution is in liquidation of the partner's interest in the partnership, the gain must be allocated to capital assets.

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Section 754
Section 734(b)(1)(A) – No Step Up

- Partner receives a distribution of cash from the partnership.
- The cash distribution equals the partner's outside basis in its partnership interest.
- Partner does not recognize gain on the distribution.
- Partnership does not adjust the basis of undistributed partnership assets.

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Section 754
Section 734(b)(1)(A) – Step Up

- Partner receives a distribution of cash from the partnership.
- The cash distribution is in excess of the partner's outside basis in its partnership interest.
- Partner recognizes gain on the distribution in the amount of such excess.
- Partnership steps us the basis of undistributed partnership assets by the amount of gain recognized by the partner.

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Section 754
Section 734(b)(1)(B) – Step Up

- Partner receives a distribution of property from the partnership.
- Partner's basis in the distributed property equals the partner's outside basis in its partnership interest.
- Partner's share of the partnership's basis in the property is in excess of the partner's outside basis in its partnership interest:
  - Therefore Section 732(a)(2) applies.
- Partnership steps up the basis of undistributed partnership assets by such excess.

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Section 754
Section 734(b)(2)(B) – Step Down

- Partner receives a distribution of property from the partnership in liquidation of its partnership interest.
- Partner's basis in the distributed property equals the partner's outside basis in its partnership interest.
- Partner's outside basis in its partnership interest exceeds the partner's share of the partnership's basis in the distributed property.
- Partnership steps down the basis of undistributed partnership assets by such excess.

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Section 754
Mechanics of the Election

- The transferee partner's share of partnership property is:
  - The transferee partner's share of the partnership's previously taxed capital; plus
  - The transferee partner's share of partnership liabilities; and
  - Treas. Reg. § 1.743-1(d)(1).
- The transferee partner's share of previously taxed capital is based on a "hypothetical transaction":
  - Sale of all partnership property immediately after the transfer of the partnership interest to transferee in a taxable transaction for cash equal to fair market value; and
  - See Treas. Reg. § 1.743-1(d)(2).

Section 754
Mechanics of the Election

- The transferee partner's share of previously taxed capital equals the sum of:
  - The cash the transferee partner would receive upon a liquidation of the partnership following the hypothetical transaction; plus
  - The tax loss allocated to the transferee partner from the hypothetical transaction; less
  - The tax gain (including Section 704(c) gain) that would be allocated to the transferee partner from the hypothetical transaction.
- Treas. Reg. § 1.743-1(d)(1).

Section 754 Example

- A is a member of ABC LLC in which the members have equal interests in capital and profits.
- ABC LLC has made a Section 754 Election.
- A sells its member interest in ABC LLC to D for $100,000 plus the assumption of A's share of ABC LLC's liabilities.
- The current assets, liabilities and capital of ABC are as shown on its balance sheet:

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Section 754--Example

Assets	Tax Basis	FMV
Cash	$ 15,000	$ 15,000
Accounts Receivable	$ 45,000	$ 40,000
Inventory	$ 50,000	$ 75,000
Equipment	$ 110,000	$ 100,000
Land & Building	$ 30,000	$ 100,000
Goodwill	$ -	$ 70,000
Total Assets	$ 250,000	$ 400,000
Liabilities & Capital		
Accounts Payable	$ 15,000	$ 15,000
Long-Term Debt	$ 85,000	$ 85,000
Member Capital		
A	$ 50,000	$ 100,000
B	$ 50,000	$ 100,000
C	$ 50,000	$ 100,000
Total Liabilities & Capital	$ 250,000	$ 400,000

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Section 754 Example

- D's outside basis in the member interest in ABC LLC is $133,333;
  - Cash Paid to A - $100,000; and
  - D's share of partnership liabilities - $33,333.
- D's share of the inside basis of ABC LLC's assets is $83,333;
  - D's interest in the partnership's previously taxed capital – $50,000;
    - Cash D would receive on a liquidation of ABC LLC following a hypothetical transaction - $100,000; plus
    - The tax loss allocated D from the hypothetical transaction - $0; less
    - The tax gain that would be allocated to D from the hypothetical transaction - $50,000.
  - D's share of partnership liabilities - $33,333.

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Section 754 Example

- Because a Section 754 Election was previously made by ABC LLC, the basis adjustment under Section 743(b) is the difference between:
  - D's outside basis in the member interest in ABC LLC - $133,333; and
  - D's share of the inside basis of ABC LLC's assets - $83,333.
- The amount of the basis adjustment would be $50,000.

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Schedule K-1(Form 1065)
Section 752

- Part II
- Question K Partner's share of liabilities BOY and EOY, including Nonrecourse, Qualified Recourse and Recourse.
- Question K now requires disclosure of liabilities from lower tier partnerships.

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Schedule K-1 (Form 1065)
Allocations of Partnership Debt

- Impacts outside basis (which cannot be negative).
- IRC Section 752 (and Treas. Reg. Section 1.752-1 updated October 2019):
  - Recourse liability;
    - Partner or related person bears the economic risk of loss; and
    - Allocate to outside basis of the partner(s) bearing the economic risk of loss.
  - Nonrecourse liability
    - Partner or related person does not bear the economic risk of loss; and
    - Allocation to outside basis in accordance with sharing ratios.

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Schedule K-1 (Form 1065) Guaranties and Deficit Restoration Obligations

- Except for when encumbered property is directly contributed or distributed, Treas. Reg. Section 1.752-1(d) describes the only situation in which a partner is considered to have assumed a partnership liability.
- A partner is considered to assume a partnership liability only if:
  - (1) the assuming person is personally obligated to pay the liability;
  - (2) the person to whom the liability is owed knows of the assumption and can directly enforce the partner's or related person's obligation for the liability; and
  - (3) no other partner or person that is a related person to another partner would bear the economic risk of loss for the liability under §1.752-2 immediately after the assumption.

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Schedule K-1 (Form 1065)

- Part III
  - Line 4a Guaranteed payments for services;
  - Line 4b Guaranteed payment for capital; and
  - Line 4c Total guaranteed payments.

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Schedule K-1 (Form 1065)

- Part III 2019 New
  - Part III Question 21 More than one activity for at-risk purposes.
  - If more than one activity, then the partnership must generally report items of income, loss and deduction separately for each activity.
  - Certain exceptions for active participation.

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Schedule K-1 (Form 1065)

- Part III 2019 New Question 22 more than one activity for passive activity purposes.
- Attachment to Schedule K-1 must provide information separately for each activity.

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Schedule K-1 (Form 1065)

- Part III 2019 Line 20 Code Z will be used to report Section 199A information (previously in 2018 Line 20 Code Z through AD were used to report Section 199A information).

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Schedule K-1 (Form 1065)

- Part III Line 20 Code Z
  - The qualified business income (QBI) deduction, also known as the Section 199A deduction, is determined at the partner level where the partner is an individual, trust, or estate. Use code Z with an asterisk (Z*) on each partner's Schedule K-1 and enter "STMT" in the entry space to indicate that the information provided on an attached statement that separately identifies the partner's distributive share of:
  - 1. Qualified items of income, gain, deduction, and loss;
  - 2. W-2 wages;
  - 3. Unadjusted basis immediately after acquisition (UBIA) of qualified property;
  - 4. Qualified publicly traded partnership (PTP) items; and
  - 5. Section 199A dividends also known as qualified real estate investment trust (REIT) dividends.

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Schedule K-1 (Form 1065)

- QBI Pass-Through Entity Reporting, or a substantially similar statement, to report information for each partner's distributive share from each trade or business;
- QBI Pass-Through Entity Aggregation Election(s), or a substantially similar statement, to report aggregated trades or businesses; and
- QBI Pass-Through Entity Reporting-Patrons of Specified Agricultural and Horticultural Cooperatives, or a substantially similar statement.

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Schedule K-1 (Form 1065)

- Part III Line 20 Code AC to report partner's share of Section 1(h)(5) gain or loss (collectibles).
- Part III Line 20 Code AD to report partner's share of deemed Section 1250 unrecaptured gain.

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Schedule K-1 (Form 1065)

- Form 8990 Limitation on Business Interest Expense Under Section 163(j)-If the partnership is required to file Form 8990, then it must report the partner's distributive share of excess business expense.
- Part III new in 2018 Box 13 Code K to report partner's excess business interest expense under Section 163(j).

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Partnership Audits

- New rules (for partnership tax years beginning after 2017).
- Partnership tax assessments are generally made for the year in which the audit is resolved.
- The IRS can now collect imputed tax underpayment, penalties and interest from the partnership directly.
- Partnership representative:
  - Sole authority to act on behalf of partnership;
  - Does not have to be a partner; and
  - Must have US presence, and be an individual or designate individual on behalf of entity.
- Statute of limitations based on partnership return (generally three years).

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Electing Out of New Rules

- 6221 Small Partnership Election – revert to Pre-TEFRA rules that require IRS to work with partnership and each partner individually:
  - Available on an annual basis if timely file and elect out;
  - Each partner is eligible (no trust or LLC, no entity taxed as a partnership);
  - 100 or less partners; and
  - Each partner is notified.
- 6226 Alternative Election – partnership furnishes to IRS and each partner statement of partner's share of adjustment
  - Irrevocable;
  - Relieves the partnership from liability (except to extent cannot get payment from partners);
  - Precludes the IRS from collecting the tax imposed from other partners;
  - Subjects each person (who was a partner during the audit year) to tax liability (but not benefit) for the year during which the partnership issues the statement; and
  - But interest is higher and partners are subject to penalties.

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