KPMG

TaxNewsFlash

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IRS releases draft version of Form 1065 instructions, partner tax basis capital reporting

The IRS today released a draft version of the instructions to Form 1065, "U.S. Return of Partnership Income" for tax year 2020. Specifically, the draft instructions contain much anticipated clarifications to the reporting requirements regarding partners' capital accounts.

The IRS today also stated that it intends to issue a notice providing additional penalty relief for the transition in tax year 2020. This to-be-issued notice will provide that solely for tax year 2020 (for partnership returns due in 2021), the IRS will not assess a partnership a penalty for any errors in reporting its partners' beginning capital account balances on Schedules K-1 if the partnership takes "ordinary and prudent business care" in following the Form 1065 instructions to calculate and report the beginning capital account balances. This penalty relief will be in addition to the reasonable cause exception to penalties for any incorrect reporting of a beginning capital account balance.

Draft instructions

The **draft of instructions to Form 1065** [PDF 1.02 MB] reflects revised instructions for partnerships required to report capital accounts to partners on Schedule K-1 (Form 1065). The draft instructions show a "watermark date" of October 21, 2020.

The draft instructions are intended to provide a preview of the changes and information that software developers would need to update their systems before the final version of the updated instructions is released in December 2020.

Comments are requested during a 30-day comment period.

Reasons for changes

As noted in a related IRS release—**IR-2020-240**—the revised instructions are part of an effort to improve the quality of the information reported by partnerships to the IRS and furnished to partners to facilitate increased compliance.

The revised instructions indicate that partnerships filing Form 1065 for tax year 2020 are to calculate partner capital accounts using the transactional approach for the Tax Basis Method.

- Under this approach, partnerships report partner contributions (net of liabilities), the partner's share of partnership net income or loss, withdrawals and distributions (net of liabilities), and other increases or decreases using tax basis principles as opposed to reporting using other methods such as GAAP.

- If it is unclear how to report an item, the partnership should account for the item in a manner generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to liabilities) and should report the amount on the line for other increases or other decreases.

- On the line for other increases and other decreases, partnerships are instructed to include section 734(b) adjustments and certain items with respect to depletion. If a section 743(b) adjustment was previously included in the partner's capital account, those section 743(b) adjustments should be removed from the partner's capital account in the 2020 tax year as another increase or decrease as well.

- Beginning balances for 2020—

  - **Tax Basis Method previously used.** If the Tax Basis Method was previously used, the partnership should report the partner's ending capital account as determined for last year on the line for the beginning capital account.

    - If a negative ending capital account was reported last year and a different amount is determined for this year, an explanation must be provided.
    - If a partner joined the partnership during the year, the opening balance should be zero.
    - If a new partner acquired an interest from another partner, the amount of the beginning capital account that is equal to the transferor partner's ending capital account with respect to the interest transferred should be included in the beginning capital.

  - **Tax Basis Method was not previously used.**

    - Partnerships that did not prepare Schedules K-1 under the Tax Basis Method for 2019, but otherwise maintain tax basis capital accounts in their books and records (for example, for purposes of reporting negative capital accounts), must report each partner's beginning tax basis capital account balance for 2020 using the Tax Basis Method.
    - Partnerships that did not report partners' capital accounts using the Tax Basis Method last year and did not maintain capital accounts under the Tax Basis Method in their books and records may refigure a partner's beginning capital account using one of the following methods as described in the instructions—
      - The Tax Basis Method,
      - The Modified Outside Basis Method,
      - The Modified Previously Taxed Capital Method, or
      - The Section 704(b) Method (which is generally the partner's section 704(b) capital account adjusted for the partner's share of section 704(c) gain or loss in the partnership's assets).
    - The same method must be used for each partner's beginning capital account.

- A statement must be attached to each partner's Schedule K-1 indicating the method used to determine each partner's beginning capital account and certain other information.

- Special rules are included for publicly traded partnerships.

The IRS in June 2020 released Notice 2020-43 seeking public comment on other possible methods (including the Modified Outside Basis Method and the Modified Previously Tax Capital Method) to report capital accounts to partners. Read ***TaxNewsFlash***

KPMG observation

The addition of the transactional approach to determine each partner's capital account under the Tax Basis Method is viewed by tax professionals as a welcomed addition to the approaches provided in Notice 2020-43, as it will allow many partnerships to more easily comply with the new reporting requirements.

According to today's IRS release, in response to Notice 2020-43, comments were received from taxpayers on other possible methods to report capital accounts to partners, and these comments requested that the Tax Basis Method approach be retained. The IRS reported that it did not receive practical alternative approaches to partner capital account reporting.

Today's IRS release states that reporting using only one method assists the IRS in assessing compliance risk, and identifying potential noncompliance, while providing compliant taxpayers' returns are less likely to be examined.

KPMG observation

The reporting of tax basis capital accounts by partnerships is intended to enhance the compliance efforts of the IRS. This has raised concerns regarding whether the partnership could be assessed with an imputed underpayment in the event of a partnership audit to the extent that there was an adjustment with respect to the reporting of tax basis capital accounts. However, the instructions provide that each partner continues to be responsible for maintaining a record of the adjusted tax basis in its partnership interest.

Lastly, the IRS stated that it intends to make similar revisions, as applicable, to Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships*.

Direct comments, including requests for subscriptions, to Washington National Tax. For more information, contact KPMG's Federal Tax Legislative and Regulatory Services Group at + 1 202.533.4366, 1801 K Street NW, Washington, DC 20006-1301.