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Insights into Schedule K-1 Reporting, Tax Basis Capital Account Reporting

On February 12, 2021, the Internal Revenue Service (IRS) released the instructions to the 2020 Form 1065, U.S. Return of Partnership Income, with early draft versions released on October 22, 2020, January 15, 2021, and February 5, 2021 (the Instructions), indicating that partnerships are required to report partner capital accounts on Item L of Schedule K-1 (Form 1065) using tax basis as determined using the transactional approach (the Tax Basis Method). In a news release, the IRS states that the recent updates to the forms and instructions are “part of a larger effort by the agency to improve the quality of information reported by partnerships and furnished to partners to facilitate increased compliance.” The recent updates to the forms and instructions are also likely to enhance the IRS’s ability to assess compliance risk and identify potential noncompliance when auditing partnerships under the new partnership audit regime, enacted as part of the Bipartisan Budget Act of 2015 (the BBA).

The Instructions provide much-anticipated guidance on the required tax basis capital account reporting for tax year 2020. As discussed in detail below, the Instructions provide that partnerships must calculate partner capital accounts using the Tax Basis Method as described in the Instructions. The Instructions also provide detail on how to determine a partner’s beginning tax basis capital account for the 2020 tax year, allowing alternative methods if the partnership did not previously report or maintain its partners’ tax basis capital accounts.

This article explains the new reporting requirements and what partnerships should be focusing on in order to comply with these new requirements.

Note that the conclusions reached in this article are based on the interpretation by KPMG of the Instructions. The discussion and conclusions below are subject to change as additional guidance from the government is released.

In what appears to be the end to the tax basis capital account reporting rollout, the IRS released the Instructions providing guidance on the required tax basis capital account reporting for the 2020 tax year. The Instructions are a follow-up to Notice 2020–43 in which Treasury and the IRS sought comments on possible methods to report partners’ capital accounts on a tax basis.

As detailed below, Item L (Partner’s Capital Account Analysis on the Schedule K-1) is now required to be reported using what the IRS describes as the Tax Basis Method. The Instructions continue to require all partnerships to complete Item L except for those small partnerships meeting the requirements of Form 1065, Schedule B, Question 4.

KPMG observation: The Instructions make clear that the **partner** is responsible for maintaining its adjusted tax basis in its partnership interest, and that the amount reported on Item L by the partnership may be different from the partner’s tax basis in the partnership.

Tax basis method

The Instructions provide guidance on how to compute each partner’s capital account using the Tax Basis Method. While the Instructions do not provide specific guidance for every situation, they do provide helpful instruction as to how a partnership should report events or transactions where uncertainty lies. Specifically, the Instructions state that “the partnership should account for the event or transaction in a manner that is generally consistent with figuring the partner’s adjusted tax basis in its partnership interest (without regard to liabilities), taking into account the rules and principles of sections 705, 722, 733, and 742.”

KPMG observation: In other words, it appears that the purpose of the tax basis capital reporting requirement is to allow the IRS to obtain an estimate of a partner’s outside tax basis, and uncertain items should be accounted for in a manner consistent with this purpose.

Beginning capital account

Generally, when using the Tax Basis Method, an existing partner’s beginning capital account will equal its prior-year ending capital account. As detailed below, the Instructions provide specific guidance to compute a partner’s beginning capital account for 2020 under various fact patterns.

Capital contributed during the year

Where a partner makes a capital contribution during the year, the partnership will enter the amount of cash plus the adjusted tax basis (reduced by any liabilities assumed by the partnership) of all property contributed by the partner to the partnership on the line for capital contributed during the year.

Current-year net income (loss)

The Instructions provide that the amount reported on the current-year net income (loss) line should equal the partner’s share of partnership income and gain (including tax-exempt income) less such partner’s share of deduction and loss (including nondeductible, noncapital expenditures), as figured for tax purposes for the year.

KPMG observation: This suggests that the aggregate amount of the partners’ current-year net income (loss) may not equal the net income (loss) amount reported on Line 1 of the Analysis of Net Income (Loss) section of the Form 1065. The current-year net income (loss) amount on Item L would not include, for example, guaranteed payments or income, gain, loss, or deductions resulting from a section 743(b) basis adjustment, whereas these items would be reported within the net income (loss) amount reported on Line 1 of the Analysis of Net Income (Loss) section of the Form 1065. Further, the current-year net income (loss) amount specifically includes tax-exempt income and nondeductibles, which are not reported within the net income (loss) amount reported on Line 1 of the Analysis of Net Income (Loss) section of the Form 1065.

Other increase (decrease)

The other increase (decrease) line is a catchall for other items that may impact a partner’s tax basis capital account during the year. **Where an amount is reported as another increase (decrease), a statement must be attached explaining each adjustment.**

The Instructions specify that transfers of partnership interests will be reported on the other increase (decrease) line. Where a partner acquires its partnership interest from another partner by purchase, exchange, gift, or inheritance, the transferee partner will “step into the shoes” of the tax basis capital account purchased from the transferor partner. That is, the transferee’s tax basis capital account may not equal the transferee’s cost basis; rather, the transferee’s tax basis capital account is equal to the portion of the transferor’s tax basis capital account attributable to the transferred interest. Further, the transferee’s tax basis capital account does not include any section 743(b) basis adjustments. Additionally, if a partner’s 2020 beginning capital account amount includes a partner’s remaining section 743(b) basis adjustment, the partnership should adjust the partner’s capital account through an other increase (decrease) to remove this amount on its 2020 return.

The Instructions also provide that certain adjustments with respect to a partner's share of depletion deductions and a partner's share of any increase or decrease to the adjusted tax basis of partnership property under section 734(b) should be included on the other increase (decrease) line.

Withdrawals and distributions

The withdrawals and distributions line should include the amount of any cash or property distributed to the partner. Where property is distributed, the capital account is reduced by the adjusted tax basis of the property distributed (reduced by any liabilities assumed by the partner).

KPMG observation: Note that the partner's tax basis capital is reduced by the partnership's adjusted tax basis in the distributed property, but that amount may be different than the adjusted tax basis of the property in the hands of the partner as determined under section 732.

Ending capital account

The ending capital amount is the sum of the amounts shown on the lines of Item L, as discussed above. The Instructions state that it is possible for a partner to have a negative tax basis capital account, as this could occur in the event a partner's distributions and share of deduction and loss exceeds such partner's contributions and share of income and gain.

KPMG observation: Where a partner has a negative tax basis capital account at the beginning or end of the tax year, the partnership may want to compare the partner's negative tax basis capital account to the partner's share of liabilities. This may be an area of potential concern and an area of interest to the IRS.

Guidance for the beginning capital account balance for the 2020 tax year

The Instructions include specific guidance to transition capital account reporting to the Tax Basis Method for the 2020 tax year. As described below, a partnership's approach to determine each partner's beginning capital account amounts will be dependent, in part, on the method reported in the prior years and in part on what records the partnership has kept.

Tax basis method previously reported

Where a partnership, on its prior-year tax return, reported capital accounts on the Tax Basis Method, a partner's beginning capital account will be equal to its prior-year ending capital account. The Instructions do not contemplate any adjustments needed in this circumstance.

KPMG observation: If it is determined that the prior-year ending capital account is not accurate, an adjustment will likely be needed through the other increase (decrease) line, with an explanation attached.

To the extent the partnership reported a partner's ending negative tax basis capital account for the prior year, and a different amount is reported as the beginning capital account for the current year, an explanation is required. As noted above, to the extent a partner's ending negative tax basis capital account, as reported on the 2019 Schedule K-1 included such partner's remaining section 743(b) basis adjustment, the 2020 beginning capital account would include the remaining section 743(b) basis adjustment, and the section 743(b) basis adjustment would be removed as an other increase (decrease) amount.

KPMG observation: It appears that any other difference should be reflected within the beginning capital account amount with an explanation attached as to why the beginning capital account amount does not equal the prior-year ending capital account reported for negative tax basis capital reporting.

Tax basis method not previously used

If a partnership reported capital accounts on other than a tax basis (i.e., generally accepted accounting principles (GAAP), section 704(b), or other basis) in the prior tax year, but maintained capital accounts in the books and records of the partnership under the Tax Basis Method (e.g., to report a partner's negative tax basis capital account in the prior year), then the partnership must report each partner's beginning capital account using the Tax Basis Method.

Where the partnership did not either report or maintain capital accounts using the Tax Basis Method in the prior year, the partnership may redetermine the partners' beginning capital account under one of the following four methods:

1. Tax Basis Method, as outlined above
2. Modified outside basis method
3. Modified previously taxed capital method
4. Section 704(b) method.

The same method must be used to determine each partner's beginning capital account. **A statement must be attached to each partner's Schedule K-1 indicating which method was used and if a partnership used the previously taxed capital method. The statement must also indicate the method used to determine the partnership's net liquidity value (e.g., fair market value or section 704(b) book value).**

Modified outside basis method

If a partnership elects to use the modified outside basis method, a partner's beginning capital account will equal the partner's outside basis, as determined using the principles of subchapter K (including sections 705, 722, 733, and 742) less such partner's share of section 752 liabilities, and less any remaining section 743(b) basis adjustment of such partner. The Instructions provide that the partnership may rely on the adjusted tax basis information provided by the partner.

KPMG observation: This method appears to require a partnership to request its partners' outside basis information (unless the partnership maintains such information), which may be manageable for a small partnership but burdensome for a partnership with many partners.

Modified previously taxed capital method

As introduced in Notice 2020–43, the modified previously taxed capital method is equal to the following:

- The amount of cash a partner would receive if the partnership liquidated after selling all its assets in a fully taxable transaction for cash equal to the "net liquidity value" of the assets, increased by
- The amount of tax loss (including any remedial allocations under Treas. Reg. section 1.704- 3(d)) that would be allocated to such partner following such a liquidation, and decreased by
- The amount of tax gain (including any remedial allocations under Treas. Reg. section 1.704- 3(d)) that would be allocated to such partner following such a liquidation.

The amount of tax loss or tax gain is calculated without regard to a partner's section 743(b) basis adjustment and assumes all liabilities are treated as nonrecourse.

In determining the "net liquidity value" of the partnership's assets, the partnership may use:

- The fair market value of the assets,
- The section 704(b) basis of the assets,
- The basis of the assets determined for financial accounting purposes
- Any other basis set forth in the partnership agreement.

As indicated above, the partnership must disclose on each Schedule K-1 the net liquidity value used to determine the partner's beginning capital account amount.

Section 704(b) method

The Instructions introduce a new approach, the section 704(b) method, to determine each partner's 2020 beginning capital account amount. Under the section 704(b) method, a partner's 2020 beginning capital account equals its section 704(b) capital account, plus or minus such partner's share of section 704(c) built-in gain or built-in loss in the partnership's assets. The Instructions indicate that basis disparities from both contributed property (i.e., a forward layer) and from any revaluation event (i.e., a reverse layer) are included in determining each partner's share of section 704(c) built-in gain or loss.

KPMG observation: The section 704(b) method outlined in the Instructions appears to contemplate only basic differences between a partner's section 704(b) capital account and tax basis capital. For instance, the Instructions do not contain guidance on the contribution of built-in loss property subject to section 704(c)(1)(C). Additionally, the section 704(b) method only refers to built-in gain or loss in the partnership's assets. The Instructions do not expressly contemplate Treas. Reg. section 1.752-7 liabilities (i.e., liabilities that have a built-in loss at the time of contribution), which are treated as section 704(c) property. While not expressly included in the Instructions, in looking back to how a partnership should report items where uncertainty lies, it seems appropriate to make further adjustments to the section 704(b) capital accounts for these items to more closely align the partners' adjusted tax basis in their partnership interest, taking into account the rules and principles of sections 705, 722, 733, and 742.

Other items

The Instructions also include special rules for publicly traded partnerships. The news release states that similar revisions will be made to Form 8865, Return of U.S. Persons with Respect to Certain Foreign Partnerships.

Penalty relief

On January 20, 2021, the IRS released an advance version of Notice 2021-13 (Notice) that provides relief for partnerships from certain penalties due to the inclusion of incorrect information in reporting their partners' 2020 beginning capital account balances on the 2020 Schedule K-1s. The Notice provides that a partnership will not be subject to a penalty under sections 6698, 6721, or 6722 due to the inclusion of incorrect information in reporting its partners' 2020 beginning capital account balances on the 2020 Schedules K-1—if the partnership can show that it took ordinary and prudent business care in following the 2020 Form 1065 instructions to report its partners' 2020 beginning capital account balances using any one of the four methods outlined in the instructions.

Also, a partnership will not be subject to a penalty under sections 6698, 6721, or 6722 for the inclusion of incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in tax year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in tax years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1 for which relief is provided by the Notice.

This penalty relief is in addition to the reasonable cause exception to penalties for failing to properly report the partners' beginning capital account balances.

Notice 2021-13 provides that a partnership is not eligible for this relief if it fails to:

- Timely file a 2020 Form 1065, Form 8865, and Schedules K-1
- Include a partner's beginning capital account balance on the Schedule K-1.

The Notice also does not relieve a ***partner*** of its obligation to determine the adjusted basis of its interest in the partnership for purposes of determining its tax liability or that of any other person pursuant to section 705 and Reg. section 1.705-1(a)(1).

The Notice further provides that the IRS will waive any accuracy-related penalty under section 6662 for any tax year with respect to any portion of an imputed underpayment that is attributable to an adjustment to a partner's beginning capital account balance reported by the partnership for the 2020 tax year to the extent the adjustment arises from the inclusion of incorrect information for which the partnership qualifies for relief under this Notice. However, the Notice does not prevent the IRS from imposing an accuracy-related penalty under section 6662 for any portion of an imputed underpayment related to capital account reporting by the partnership that is not described in the previous sentence.

KPMG observation: On the one hand, the Notice provides welcome relief from penalties for partnerships that exercise "ordinary and prudent business care" in reporting their partners' beginning capital account balances. However, on the other hand, the Notice expresses the government's view that tax basis capital is otherwise a partnership-related item under the BBA and therefore could be subject to an imputed underpayment to the extent of any adjustment to the partners' tax basis capital.

Implications

In what appears to be the end to the tax basis capital account reporting saga, the Instructions provide the much-anticipated guidance on the required tax basis capital account reporting for tax year 2020. The tax basis capital account reporting requirement is part of a larger effort by the IRS to improve the quality of information reported by partnerships, likely enhancing the IRS's ability to assess compliance risk and identify potential noncompliance when auditing partnerships under the BBA.

As discussed in detail above, partnerships are now required to report partner capital accounts using the Tax Basis Method as described in the Instructions. For partnerships that have not historically reported capital accounts on a tax basis or maintained its partners' tax basis capital accounts, the Instructions provide alternative methods for determining partners' 2020 beginning capital account balances. The best method to use for any given partnership will be based on the facts and circumstances of that particular partnership. When choosing a method, it's important to consider the availability of data required for each method, time constraints, and cost. Look for *Insights into Schedule K-1 Reporting: Choosing a Method for Tax Basis Capital Reporting*, which will provide a deep dive of the consideration for each of the alternative methods.

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