Tax Capital Reporting - Notice Requesting Comments

Notice 2020-43

I. PURPOSE

Partnerships and certain other persons report partner capital accounts in Box L on the Schedule K-1 (Form 1065) or in Box F on the Schedule K-1 (Form 8865), each as they currently appear on the 2019 forms (Tax Capital Reporting Requirement). The final versions of these 2019 forms and their instructions provide that partnerships and other persons must report partner capital accounts consistent with the reporting requirements in the 2018 forms and instructions, including the requirement to report negative tax basis capital accounts on a partner-by-partner basis.

The purpose of this notice is to seek public comment on a proposed requirement for partnerships to use only one of two alternative methods described in section III of this notice to satisfy the Tax Capital Reporting Requirement with respect to partnership taxable years that end on or after December 31, 2020. As a result, partnerships and certain other persons would no longer be permitted to report partner capital accounts using any other method, including § 704(b) of the Internal Revenue Code (Code) and U.S. generally accepted accounting principles (GAAP). Comments received in response to this notice will help inform the development of the instructions to be included in Form 1065, *U.S. Return of Partnership Income* (to which the instructions for Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, refer), and *Partner's Instructions for Schedule K-1 (Form 1065)*, for taxable year 2020.

II. BACKGROUND

The 2019 instructions for Form 1065 and Partner's Instructions for Schedule K-1 (Form 1065), like the 2018 instructions for these forms, require that a partnership reporting its partners' capital on a method other than the tax basis method report a partner's tax capital account at both the beginning and the end of the partnership's taxable year if either amount is negative with respect to the partner. The 2019 instructions for Form 8865, Schedule K-1, incorporate this requirement by reference to the instructions for Form 1065.

On April 5, 2019, the IRS released Form 1065 Frequently Asked Questions (FAQs) explaining how a partnership should determine a partner's tax capital account and providing a safe harbor approach based on a partner's outside basis in its partnership interest. Thereafter, early releases of drafts of the 2019 Form 1065 and the 2019 Form 8865, released September 30, 2019, and related draft instructions for the 2019 Form 1065 (to which the draft instructions for the 2019 Form 8865 refer), and the 2019 Partner's Instructions for Schedule K-1 (Form 1065), released October 29, 2019, expanded partner tax capital reporting to require all partnerships and certain other persons who file Form 8865 to report all partners' tax capital accounts using the tax basis method.

In response to the change requiring all partnerships to report their partners' tax capital on a tax basis method, commenters stated that some partnerships might be unable to comply, either in a timely manner or ever. These commenters explained that partnerships that have not historically maintained partner tax capital accounts may face difficulties in calculating their partners' tax capital by means of a historical transactional analysis of events. Commenters stated that a partnership would find such a transactional analysis particularly difficult and burdensome where the partnership has been operating for many years and either documentation regarding historical transactional events affecting partner tax capital no longer exists, or the documentation does exist, but its volume or complexity precludes reconstruction of accurate tax capital accounts. In addition, commenters asked for guidance on how to calculate tax capital using a transactional analysis under complicated transactions and structures.

Accordingly, the Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) released Notice 2019-66, 2019-52 I.R.B. 1509 on December 11, 2019, removing the requirement that partnerships and other persons required to furnish and file Form 1065, Schedule K-1 or Form 8865, Schedule K-1, report partner capital accounts in Item L of the 2019 Form 1065, Schedule K-1, or in Item F of the 2019 Form 8865, Schedule K-1, using the tax basis method for 2019. In addition, Notice 2019-66 announced that further guidance would be provided regarding the definition of partner tax capital. In lieu of providing a definition of tax basis capital, this notice proposes two methods that satisfy the Tax Capital Reporting Requirement. Section III of this notice describes the two proposed methods for complying with the Tax Capital Reporting Requirement. Part IV of this notice requests comments on those proposed methods. The Treasury Department and the IRS anticipate that the two proposed methods outlined in section III of this notice will be the only methods that meet the Tax Capital Reporting Requirement for partnership taxable years ending on or after December 31, 2020.

III. PROPOSED METHODS FOR COMPLYING WITH THE TAX CAPITAL REPORTING REQUIREMENT FOR TAXABLE YEARS ENDING ON OR AFTER DECEMBER 31, 2020

Commenters have indicated that many partnerships that currently possess partner tax capital information generally develop and maintain partner tax capital by applying the provisions and principles of subchapter K of chapter 1 of the Code (subchapter K), including those contained in §§ 705, 722, 733, and 742 of the Code, to relevant partnership and partner events. In such a situation, commenters have indicated that partnerships maintaining tax capital (i) increase a partner's tax capital account by the amount of money and the tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner, and (ii) decrease a partner's tax capital account by the amount of money and the tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner (Transactional Approach).

The Treasury Department and the IRS understand that many partnerships and other persons have maintained partner tax capital accounts according to the Transactional Approach, but due to the array of transactions that might affect partner tax capital, it is possible that partnerships and other persons that have been using the

Transactional Approach may not have been adjusting partner tax capital accounts in the same way under similar fact patterns. Several commenters explained that providing detailed guidance that would make the Transactional Approach consistent in all potential transactions would be a major project that would consume significant IRS resources.

The IRS and Treasury believe that a consistent framework for all partnerships and other persons to comply with the Tax Capital Reporting Requirement will aid the IRS in administering the tax law, and consistency will ultimately reduce complexity of the preparation of partnership returns. Accordingly, this notice proposes two alternative methods that a partnership would be required to use to comply with the Tax Capital Reporting Requirement. For such purpose, a partnership may report, for each partner, either (i) the partner's basis in its partnership interest, reduced by the partner's allocable share of partnership liabilities, as determined under § 752 of the Code (Modified Outside Basis Method) or (ii) the partner's share of previously taxed capital, as calculated under a modified version of § 1.743-1(d) of the Income Tax Regulations (Modified Previously Taxed Capital Method). Both methods are further described below. It is intended that a partnership must use one of these two methods for purposes of satisfying the Tax Capital Reporting Requirement and the method selected must be used with respect to all of the partnership's partners. Capital account amounts based on the Transactional Approach will not satisfy the Tax Capital Reporting Requirement. For taxable years after 2020, a partnership may change its Tax Capital Reporting Requirement method from the Modified Outside Basis Method to the Modified Previously Taxed Capital Method, or vice versa, by attaching a disclosure to each

Schedule K-1 describing the change, if any, to the amount attributable to each partner's beginning and end of year balances, and the reason for the change.

(1) The Modified Outside Basis Method

A partnership may satisfy the Tax Capital Reporting Requirement by determining, or being provided by its partners, the partner's adjusted basis in its partnership interest, determined under the principles and provisions of subchapter K (including those contained in §§ 705, 722, 733, and 742), and subtracting from that basis the partner's share of partnership liabilities under § 752.

If the partnership is satisfying the Tax Capital Reporting Requirement by using the Modified Outside Basis Method, a partner must notify its partnership, in writing, of any changes to the partner's basis in its partnership interest during each partnership taxable year other than changes attributable to contributions to and distributions from the partnership and the partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's schedule K-1. The partner must provide such written notification of such changes to the partner's basis within thirty days or by the taxable year-end of the partnership, whichever is later. For example, if a person purchases an interest in a partnership that has chosen to use the Modified Outside Basis Method, the purchasing partner must notify the partnership of its basis in the acquired partnership interest, regardless of whether the partnership has an election under § 754 of the Code in effect or has a substantial built-in loss, as defined in § 743(d) of the Code, at the time of such interest purchase. For purposes of the Modified Outside Basis Method, a partnership is entitled to rely on the partner basis information that the partnership is provided by its partners unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous.

(2) Modified Previously Taxed Capital Method

A partnership that does not satisfy the Tax Capital Reporting Requirement by using the Modified Outside Basis Method would be required to do so by using the Modified Previously Taxed Capital Method. Section 1.743-1(d)(1) generally provides that a partnership interest transferee's (transferee's) share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. The regulation further provides that the transferee's previously taxed capital is equal to—

(i) The amount of cash that the partner would receive on a liquidation of the partnership following a hypothetical transaction; increased by

(ii) The amount of tax loss (including any remedial allocations under § 1.704-3(d) of the Income Tax Regulations) that would be allocated to the partner from the hypothetical transaction; and decreased by

(iii) The amount of tax gain (including any remedial allocations under § 1.704-3(d)) that would be allocated to the partner from the hypothetical transaction.

The hypothetical transaction is a disposition by the partnership of all of its assets in a fully taxable transaction for cash equal to the fair market value of the assets. See § 1.743-1(d)(2).

Part (i) of the above calculation is intended to quantify, for each partner, the partner's economic right to a share of the distributable proceeds of the partnership immediately after the hypothetical transaction and the payment by the partnership of all of its liabilities (partnership net liquidity value). The Treasury Department and the IRS understand that although some partnerships may be able to determine the fair market value of their assets for each taxable period, such information will not be readily available for all partnerships. In most instances, a partnership that calculates its partnership net liquidity value by using a consistent measurement for the value of its assets (such as GAAP basis or § 704(b) basis) rather than their actual fair market value will determine the same amount for each of its partners as would be determined if the partnership had calculated its partnership net liquidity value by hypothesizing a sale of its assets for actual fair market value. Accordingly, for purposes of the Tax Capital Reporting Requirement, the Modified Previously Taxed Capital Method modifies the calculation described in § 1.743-1(d)(2) (for purposes of the Tax Capital Reporting Requirement only) as follows:

(i) The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the hypothetical transaction would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership net liquidity value and gain or loss by using such assets' bases as determined under § 704(b), GAAP, or the basis set forth in the partnership agreement for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and

(ii) All liabilities are treated as nonrecourse for purposes of parts (ii) and (iii) of the calculation referring to gain or loss, respectively. This is to avoid the burden of having to characterize the underlying debt and to simplify the computation.

Example – Facts. A and B are equal partners in AB LLC, a calendar-year partnership. On December 31, 2020, AB LLC's balance sheet reflects the following assets and liabilities:

- $500 of cash;
- Inventory with a tax and book basis of $1,000;
- Equipment with a tax and book basis of $500;
- Land with a tax and book basis of $1,000; and
- A long-term loan of $5,000.

AB LLC chooses to comply with the Tax Capital Reporting Requirement by using the Previously Taxed Capital Method and calculating liquidation values, gains, and losses, based on the book basis of the assets. Each of A and B's Previously Taxed Capital under that method would be $(1,000), an amount equal to (i) the cash each would receive after the hypothetical liquidation (zero, because the debt of $5,000 exceeds the $3,000 book basis of the assets), less (ii) gain that would be allocated to each partner on the hypothetical liquidation and sale ($1,000, each partner's 50% share of the excess of the $5,000 amount realized on a sale of the property for the debt over the tax basis of $3,000), plus (iii) loss that would be allocated to each partner (zero).

A partnership that adopts the Modified Previously Taxed Capital Method would be required, for each taxable year in which the method is used, to attach a statement indicating that the Modified Previously Taxed Capital Method is used and the method it used to determine its partnership net liquidity value (for example, fair market value, §704(b) book basis, etc.).

IV. REQUEST FOR COMMENTS

The Treasury Department and the IRS request comments on the following topics:

(i) Whether the methods used to satisfy the Tax Capital Reporting Requirement described in section III of this notice should be modified or adopted;

(ii) Whether an ordering rule should apply to the basis used in determining the partnership's net liquidity value; for example, use of fair market value is required, but if not readily available, §704(b) book basis is required, and, if the partnership does not maintain § 704(b) capital, GAAP is required, etc.;

(iii) How, if at all, the Tax Capital Reporting Requirement should be modified to apply to partnerships that are treated as publicly traded partnerships under § 7704 of the Code;

(iv) Whether the Transactional Approach, or similar method, should be permitted for purposes of meeting the Tax Capital Reporting Requirement and, if recommended, what additional guidance would be necessary; and

(v) Whether and in what circumstances limitations should be imposed on partnerships to change from one method to another (for example, whether there should be a limit on how many times the method can be changed over a period of years), including compliance with such rules in the case of the merger of partnerships using different methods.

Written or electronic comments must be received by **August 4th, 2020**, and should contain a reference to Notice 2020-43. Commenters are strongly encouraged to submit comments electronically, as access to mail may be limited. Comments may be submitted in one of two ways:

(1) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS Notice 2020-43 in the search field on the regulations.gov homepage to find the docket for this notice and submit comments).

(2) Alternatively, by mail to Internal Revenue Service, CC:PA: LPD (Notice 2020-43, Room 5207, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Comments will be available for public inspection and copying.

V. DRAFTING INFORMATION

The principal author of this notice is Kara Altman of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice contact Kara Altman at (202) 317-5576 (not a toll-free call).