Tax Notes

Complying with the Tax Basis Capital Requirement

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The IRS confirmed in October that partnerships would need to report partners' capital accounts on the tax basis. After previous delays, tax basis capital reporting will be required on all Forms 1065, Forms 8865 and Schedules K-1 starting with the 2020 tax year. For many taxpayers, this may mean having to recalculate partner capital account balances within the next six weeks.

The Hard Part First: Beginning 2020 Tax Capital

Except for taxpayers that previously reported Schedule K-1 capital accounts on the tax basis or that otherwise maintained tax basis capital accounts in their internal books and records, partnerships will need to compute beginning capital account balances for 2020. The IRS provided four methods for calculating a partner's beginning tax capital account balance:

- Transactional Method (Tax Basis Method) – inception-to-2020 contributions, distributions and taxable income (and tax-exempt income and non-deductible expenses)
- Modified Outside Basis Method – partner's outside basis in its partnership interest, less the partner's shares of partnership liabilities and Section 743(b) adjustments
- Modified Previously Taxed Capital Method (Hypothetical Liquidation Method) – the cash the partner would receive if the partnership liquidated immediately following the taxable sale of all of its assets for their fair market values (FMV), plus the tax losses and less the tax gains that would be allocated to the partner in the hypothetical transactions [excluding 743(b) adjustments]
- Section 704(b) Method – partner's 704(b) capital account, less share of 704(c) gain and plus share of 704(c) loss

Beginning Tax Capital in Practice

Most partnerships will likely end up using either the transactional or the modified previously taxed capital method. When complete information is available extending back to the beginning of the partnership's life, and particularly with newer partnerships, the transactional method is likely to be the simplest and least labor-intensive method.

In most other situations, where full information is not available or the partnership's longevity makes the transactional method unwieldly, the modified previously taxed capital method may be the only available option. The difficulty of this method depends directly on the complexity of the liquidation provisions in the partnership's operating agreement. This method also requires determining the tax basis and FMV of the partnership's assets. Although most partnerships do not know the FMV of their assets, the IRS permits the use of book/GAAP or Section 704(b) values (or other values permitted by the operating agreement).

Usage of the other two methods is expected to be uncommon, although they may be the least demanding options when they are available. The modified outside basis method is very easy to apply and understand, but is only available if every partner provides its basis in its partnership interest. The Section 704(b) method may also be relatively straightforward, but requires the existence of Section 704(b) capital accounts.

Next: the Easy Part

After beginning tax basis capital is calculated, activity is recorded in the capital accounts on the tax basis going forward. Contributions and distributions of assets are recorded using the assets' tax basis, not the FMV or book value. Current year net income and loss tracks taxable income, tax-exempt income and non-deductible expenses and not book income. Other increases or decreases on the Schedule K-1 should report items such as transferred capital and Section 734(b) adjustments.

Partnership capital accounts reported on Form 1065 (and 8865) Schedule M-2 will also be reported on the tax basis and should generally correspond to the total of the amounts reported on the partners' Schedules K-1. In addition, unless the partnership's balance sheet is reported (on Schedule L) on the tax basis, the balance sheet capital account balance will not correspond to the balances reported on Schedule M-2 or the Schedules K-1.

Penalty Relief

On January 19, 2021, the IRS released Notice 2021-13 that outlines penalty relief to taxpayers related to the new tax basis capital requirement. Penalties due to the inclusion of incorrect beginning capital account balances on 2020 Schedules K-1 are eligible for relief. Penalty will not be imposed if the partnership took "ordinary and prudent business care" in following the Form 1065 instructions to report beginning tax capital using any of the four methods outlined. No relief is available if the return is not timely filed or its beginning capital account balances are not included on the filed Schedules K-1.

Penalties for incorrect ending 2020 tax capital or for beginning or ending tax capital in any later years would also not be imposed if the errors were solely attributable to incorrect beginning 2020 tax capital, for which relief would also be available. Similarly, accuracy-related penalties for imputed underpayments resulting from an adjustment to a partner's beginning 2020 tax capital are eligible for relief where the adjustment is due to incorrect information for which the partnership qualifies for relief.

Contact Us

For further guidance and assistance, please reach out to your PKF O'Connor Davies tax advisor, or to Christopher Johnson, Senior Manager at cjohnson@pkfod.com or Thomas J. Riggs, Partner at triggs@pkfod.com. We are here to help you.