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Insights into Schedule K-1 Reporting, Choosing a Method for Tax Basis Capital Reporting

Client impact:

On February 12, 2021, the Internal Revenue Service (IRS) released the Form 1065 Instructions, with early draft versions released on October 22, 2020, January 15, 2021, and February 5, 2021, (the Instructions) indicating that partnerships are to report partner tax basis capital accounts on Item L of the Schedule K-1 (Form 1065) using the transaction approach (described within the Instructions). The Instructions provide much-anticipated guidance on the required tax basis capital account reporting for tax year 2020, including providing four methods to determine a partner's beginning tax basis capital account for the tax year 2020 if the partnership did not previously report or maintain the partners' tax basis capital accounts. For a detailed discussion on the new reporting requirements contained in the Instructions, see Schedule K-1 Reporting: Tax Basis Capital Accounts, *Tax Insights* (November 5, 2020).

This article discusses the technical and procedural considerations when choosing a method to determine each partner's beginning tax basis capital account.

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

Background and analysis

In what appears to be the end to the tax basis capital account reporting saga, the IRS released the Instructions on October 22, 2020, with an updated version released on January 15, 2021. **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."** Acknowledging that partnerships may have not historically reported Item L on a tax basis, the Instructions include specific guidance to transition capital account reporting to the tax basis method for the 2020 tax year. As discussed in detail in *Insights into Schedule K-1 Reporting: Tax Basis Capital Reporting,* where a partnership historically reported capital accounts on other than a tax basis (e.g., generally accepted accounting principles (GAAP), section 704(b), or other basis) and did not otherwise maintain tax basis capital accounts, a partnership may determine its partners' beginning tax basis capital accounts under one of the following four methods:

1. Tax basis method
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.

Determining the best method

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. Considerations for each method are described in detail below.

Tax basis method

To determine the partners' 2020 beginning capital accounts for a partnership using the tax basis method, this method will require a partnership to create a tax basis capital account rollforward from inception using the transactional approach described in the Instructions. Although many partnerships may already have this information, for those that do not, the most significant limiting factor of the tax basis method will be the availability of data. Partnerships will need prior-year Schedules K-1 and/or prior-year workpapers to extract the components of each partners' tax basis capital (e.g., contributions, distributions, taxable income, transfers, etc.) to reconstruct and roll tax basis capital from inception. Given that tax return preparers may present the Schedules K-1 and accompanying footnotes differently, the Schedules K-1 and footnotes may not provide consistent, sufficient, and/or reliable information to quantify or identify a tax basis capital component. In those cases, partnerships may need additional details from their prior-year workpapers and supporting documents. The following are some examples of where a partnership may need to spend additional time to develop the required information:

— **Property contributions** – The face of the Schedule K-1 may not provide the tax basis of the property contributed, especially if the capital accounts were reported on a basis other than tax (e.g., GAAP or section 704(b)). Item M of the Schedule K-1 may provide detail regarding the fair market value and tax basis of contributed built-in gain or loss property.

— **Property distributions** – As with property contributions, the face of the Schedule K-1 may not provide the tax basis of the property distributed, especially if the capital accounts were reported on a basis other than tax (e.g., GAAP or section 704(b)). Line 19C (or Line 19B for the 2007 and earlier tax years) may provide detail regarding the fair market value and tax basis of distributed property.

— **Income, gain, loss, or deductions related to section 743(b) basis adjustments** – Section 743(b) basis adjustments are not taken into account in calculating a partner's tax basis capital. Historically, partnerships have used many different methods of reporting a partner's section 743(b) adjustment. For instance, some may have reported items related to section 743(b) basis adjustments on Line 20 as an informational footnote only, on Line 11F (Other Income), on Line 13W (Other Deductions), and/or the line number to which the section 743(b) basis adjustment relates (e.g., Line 1 (Ordinary Business Income or Loss)). Care should be exercised to identify years where this is relevant and to exclude these amounts from the determination of tax basis capital. The section 743(b) amounts may also have only been reported on a statement providing detail to the corresponding line.

— **Sale or exchange of a partnership interest** – The Schedule K-1 for the prior years may not include information regarding the tax basis of the transferred capital accounts. The transferee partner generally steps into the shoes of the selling partner's capital accounts and tax attributes. Partnerships may need to look at prior-year workpapers or redetermine the tax basis capital of both the transferor and transferee partner.

— **Oil and gas depletion** – A partner's tax basis capital is reduced by the partner's distributive share of tax deduction for depletion of any partnership oil and gas property but should not exceed the partner's share of the adjusted tax basis of that property. Line 20T (Depletion information—oil and gas) may provide detail regarding oil and gas depletion (or Line 20N for the 2006 and earlier tax years) that needs to be considered in the analysis.

Depending on the number of years and partners involved, this process could be a significant investment of time and cost.

Modified outside basis method

To determine each partner's 2020 beginning capital account under the modified outside basis method, the partnership will start with each partner's outside tax basis and reduce that amount by the partner's share of liabilities and any remaining section 743(b) adjustment. This method generally requires a partnership to request the outside tax basis information from its partners. A partner's share of debt and remaining section 743(b) basis adjustment should be easily obtained, as both items were required to be reported on the 2019 Schedules K-1. From a time and cost perspective, this may be one of the better options as the burden is on the partners to calculate and provide the detail. However, as the partnership is relying on the partners, the partnership should consider whether all of its partners are able to provide the information, whether the information would be timely and whether the request could cause investor relation concerns. Because the Instructions indicate that the same method must be used to determine all partners' beginning capital accounts, it may significantly limit a partnership's ability to use this method. If just one partner does not timely provide their adjusted tax basis in their partnership interest, the partnership will not be able to utilize the modified outside basis method.

Modified previously taxed capital method

Under the modified previously taxed capital method, the partnership will compute each partner's previously taxed capital in a similar manner to the computation of a section 743 adjustment, with certain modifications described in the Instructions. A partner's previously taxed capital is equal to:

1. The amount of cash the partner would receive if the partnership were liquidated in a hypothetical transaction, increased by
2. The amount of tax loss that would be allocated to the partner from the hypothetical transaction, decreased by
3. The amount of tax gain that would be allocated to the partner from the hypothetical transaction.

To determine the amount of cash a partner would receive upon a hypothetical liquidation, partnerships must determine the entitlement of such partner upon the partnership's disposition of all the partnership assets using the "net liquidity value" of the partnership. The Instructions grant the partnership flexibility in determining its net liquidity value, including the use of 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, or any other basis set forth in the partnership agreement. Note that the choice of net liquidity value may impact the tax basis capital amount computed.

The partnership will then determine each partner's share of tax loss or tax gain. In determining the tax allocations, the partnership must determine each partner's section 704(b) gain or loss on the hypothetical liquidation of the assets of the partnership and then adjust the section 704(b) gain or loss allocations for section 704(c), if applicable, to determine each partner's share of tax gain or loss.

Thus, to determine each partner's 2020 beginning capital account balance using the modified previously taxed capital method, the following items are needed:

1. Tax basis balance sheet
2. Section 704(b) balance sheet
3. Fair market value balance sheet (or substitute)
4. Hypothetical gain/loss workpapers used to determine each partner's entitlement on the hypothetical liquidation, share of section 704(b) gain or loss, and impact of any section 704(c) gain or loss.

As this method does not rely on the availability of historical data, this method may be more common for partnerships that cannot use the tax basis method. The time and cost constraints for this method would be similar to computing a section 743(b) basis adjustment with respect to a sale or exchange of partnership interest and will depend on the complexity of the partnership. For example, where a partnership has a complex liquidation waterfall with multiple layers of section 704(c), this method may be very complex and time consuming. However, for a less complex partnership with no section 704(c), this calculation may be fairly straight forward.

Section 704(b) method

Under the section 704(b) method, a partner's 2020 beginning capital account equals such partner's section 704(b) capital account, less such partner's share of section 704(c) built-in gain in the partnership's assets, and plus the partner's share of section 704(c) built-in loss in the partnership's assets. Thus, to determine the partners' beginning capital accounts under the section 704(b) method, partnerships will need each partner's 704(b) capital account amount and each partner's remaining share of section 704(c) built-in gain or built-in loss, which should be reported on Item N (Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)) of the Schedule K-1. This method relies on the partnership having properly tracked its historic section 704(b) capital accounts and section 704(c) gain and loss amounts. Where a partnership can use this method, the effort should be relatively minimal assuming the section 704(b) capital account and section 704(c) built-in gain or built-in loss information were appropriately tracked.

Implications

For partnerships that have concerns computing tax basis capital under the tax basis method, the ability to use the alternative methods is welcome relief. The amount of effort depends on the method, so partnerships should carefully consider the guidance in the Instructions and choose a method taking into account the considerations described above.

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