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Tax Notes

No More Delays: Tax-Basis Capital Account Reporting Is Here

By Benjamin Beskovic, CPA, Partner, and Christopher Johnson, JD, LLM, CPA , MBA, Senior Manager

As the year 2020 comes to a close, partnerships should be prepared for some major adjustments regarding certain tax reporting requirements. The most significant change, which will take effect in a few months starting with the 2020 tax returns, is the new requirement to present partners' capital accounts on the tax basis. Partnerships and their providers will need to review and update their records to ensure that they will be able to provide tax-basis capital account details with their next tax returns.

Tax-Basis Capital Accounts

On October 22, 2020, the IRS released draft instructions to Form 1065 for the 2020 tax year. The instructions confirm that partnerships must report partners' capital accounts using the tax-basis method. The IRS also clarified that the tax-basis capital account determined by the partnership may not equal the partner's tax basis in its partnership interest for a number of reasons, and reiterated that each partner is responsible for maintaining its own record of its tax basis in the partnership interest.

For purposes of reporting year 2020 contributions, distributions and current net income/(loss), partnerships must follow the "transactional approach." Under this approach, activity is reported consistently with how such transaction impacts the partner's basis in its partnership interest under the provisions of the Internal Revenue Code (IRC). For example, a property contribution by a partner will increase the partner's tax-basis capital account by the amount of the partner's tax basis in the contributed asset, and not by the value of the asset.

The instructions explain how to calculate beginning tax-basis capital account balances if the partnership has not previously maintained such information. In such case, the beginning balances may be determined using the transactional approach, the modified outside basis method, the modified previously taxed capital method, or the §704(b) method. The partnership must use the same method to calculate the balances of all partners, and include a statement with each Schedule K-1 indicating which method was used as follows:

- The **Modified Outside Basis Method** involves the partnership determining, or being provided by its partners, the partner's adjusted outside basis in the partnership interest, as determined under general federal income tax laws, and subtracting the partner's share of partnership liabilities. The partnership may rely on the tax basis information provided by its partners.

- Under the **Modified Previously Taxed Capital Method**, a partner's beginning capital account balance would equal

  - the amount of cash that the partner would receive on liquidation of the partnership following the hypothetical 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, **plus**
  - the tax loss that would be allocated to the partner in the hypothetical disposition, **less**
  - the tax gain that would be allocated to the partner in the hypothetical disposition.

  To determine the net liquidation values, partnerships are permitted to use, rather than fair market value, asset values as determined for purposes of IRC §704(b), GAAP, or as otherwise provided in the partnership agreement. The valuation method must be used by a partnership for all partners, and indicated in a statement on the partner's Schedule K-1.

- The **<u>§704(b) Method</u>** calculates the beginning capital account balance as:

  - the partner's §704(b) capital account [capital accounts as determined in accordance with the capital account maintenance regulations under IRC §704(b)], **less**
  - the partner's share of §704(c) built-in gain, **plus**
  - the partner's share of §704(c) built-in loss. [§704(c) built-in gain or loss results from certain asset contributions to the partnership or asset revaluations.]

The instructions also clarified a few specific reporting concerns:

- A new partner who acquires an interest from another partner – through purchase, gift, inheritance or otherwise – shall report as its beginning tax-basis capital account an amount that is equal to the transferor's ending tax-basis capital account.
- Partners' shares of adjustments to the basis of partnership assets under IRC §734(b) (related to certain property distributions) should be reflected as "Other Increase/(Decrease)" to the partners' tax-basis capital accounts.
- Adjustments to the basis of partnership assets under IRC §743(b) (related to certain transfers of partnership interests), however, should <u>not</u> be reflected in the tax-basis capital accounts.

Next Steps

Partnerships will be required to calculate and report partner capital accounts on the tax basis on their 2020 tax returns and Schedules K-1. For partnerships that have not previously maintained tax-basis capital accounts, they should evaluate the various approaches provided for calculating opening balances, to determine the feasibility of implementation. Pursuant to the most recent IRS guidance, partnerships and their advisors should be ready, if needed, to:

- Compile historical documentation of partners' contributions, distributions and other tax-relevant items;
- Request details from partners regarding their adjusted tax basis in their partnership interests; and
- Select a method to calculate opening tax-basis capital account balances and, if using the modified previously taxed income method, the applicable valuation metric.

Partnership agreements and subscription documents should also be reviewed and revised if necessary. For example, it may be desirable to change the basis of certain partnership recordkeeping to track the tax-basis capital account balances or to mandate that partners comply with all reasonable information requests in order to compute tax-basis capital.

Contact Us

If you have any questions or need assistance, please contact your PKF O'Connor Davies tax advisor or either of the following:

Benjamin Beskovic, CPA
Partner
bbeskovic@pkfod.com | 646.449.6379

Christopher Johnson, JD, LLM, CPA, MBA
Senior Manager
cjohnson@pkfod.com | 646.449.6305

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