

December 23, 2019

Partnership Tax Matters

Happy holidays! This edition of *Partnership Tax Matters* focuses on recent developments with respect to reporting standards for federal tax partnerships, as described by the Internal Revenue Service (“IRS” or “Service”) in Notice 2019-66, which was released on December 9. First, we summarize the changes that were previously proposed by the IRS for partnerships’ 2019 reporting on Schedules K-1 accompanying Forms 1065 and 8865. We then discuss the Service’s recent decision to delay implementation of certain of the proposed changes until 2020, as well as other modifications to the Service’s original proposals.

Notice 2019-66: Delayed Implementation of Partnership Reporting of “Tax Basis Capital” and “Section 465 At-Risk Activities”

Background

In late September, the IRS released drafts of the 2019 Schedule K-1 related to Form 1065 (U.S. Return of Partnership Income) and Form 8865 (Return of U.S. Persons with respect to Certain Foreign Partnerships). Changes from the 2018 versions of the draft Schedules K-1 originally released by the IRS included the following (the “2019 Reporting Proposals”):

1. Each partner’s beginning and ending capital accounts (and the associated analysis of changes in the capital account) were to be reported on the “tax basis,” regardless of whether such partner’s beginning and/or ending capital account balances were negative.
2. Partnerships became required to report each partner’s share of “net unrecognized Section 704(c) gain or loss.”
3. Partnerships that are engaged in more than one activity for purposes of the “at-risk” rules under Section 465 of the Internal Revenue Code of 1986, as amended (the “Code”), became responsible for reporting various items of information (e.g., income, loss, deduction, distributions, and partner loans) *separately* with respect to each such activity.

The 2019 Reporting Proposals were heavily criticized by tax practitioners both substantively and procedurally. In particular, tax professionals argued that the proposed modifications imposed

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legal requirements whose scope was based on ambiguous terms of art (i.e., “tax basis capital accounts” and “net unrecognized Section 704(c) gain or loss”) without properly defining them. In addition, certain commentators raised the concern that the notice period provided for effectuating the 2019 Reporting Proposals was unduly burdensome, given the amount of time that filers would need to gather and compile the required information. Finally, and perhaps most importantly, practitioners suggested that adoption of the 2019 Reporting Proposals would be procedurally unfair without also providing an opportunity for advance notice and public comment in the manner typically afforded other types of IRS guidance.

Prior Rules for Reporting “Tax Basis Capital Accounts”

Historically, Schedule K-1 had required information regarding partners’ capital accounts, but it permitted various methodologies for reporting such accounts, including “tax basis,” GAAP, Code Section 704(b) book, or other methods. Notably, for 2018, partnerships were required for the first time to provide information regarding partners’ “tax basis capital accounts” for any partner that had a negative balance in its beginning or ending tax basis capital account during the year. For this purpose, the Instructions to the 2018 Schedule K-1 defined “tax basis capital” as “(i) the amount of cash plus the tax basis of property contributed to a partnership by a partner minus the amount of cash plus the tax basis of property distributed to a partner by the partnership, net of any liabilities assumed or taken subject to, in connection with such contribution or distribution, plus (ii) the partner’s cumulative share of partnership taxable income and tax-exempt income; minus (iii) the partner’s cumulative share of taxable loss and nondeductible, noncapital expenditures.”

Despite the foregoing requirement of reporting negative tax basis capital in the 2018 Schedules K-1 (Forms 1065 and 8865), the IRS agreed in Notice 2019-20 to waive penalties that might otherwise apply (e.g., under Code Sections 6722, 6698, and 6038) as a result of late provision of negative tax capital account information for 2018, provided that any partnership seeking such relief (1) timely filed partner Schedules K-1 and timely provided them to partners and (2) later provided the IRS with a schedule setting out information regarding partners having negative tax basis capital accounts no later than 180 days after the 6-month extended due date for filing Form 1065. This grant of relief by the IRS in March of 2019 was motivated by its realization that certain partners and partnerships would be unable to comply with the requirement for 2018 on a timely basis.

Notice 2019-66

The IRS’s release of Notice 2019-66 on December 9, 2019, responded to the negative feedback it had received regarding the 2019 Reporting Proposals, including significant concerns regarding

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the ability of partners and partnerships to comply with the 2019 Reporting Proposals on a timely basis. The key aspects of Notice 2019-66 were as follows:

1. The general requirement of reporting partners' capital accounts on the "tax basis" will be effective for partnership tax years that begin on or after January 1, 2020 (rather than 2019). For 2019, reporting must be consistent with capital account reporting requirements for 2018 (i.e., reporting negative tax basis capital accounts on a partner-by-partner basis). Presumably, the IRS has determined that no delay is required with respect to reporting *negative* tax basis capital accounts for 2019 because the bulk of the work with respect to determining such account balances already will have been done for 2018.

Notice 2019-66 also reminds taxpayers that further guidance for computing tax basis capital accounts is provided in Frequently Asked Questions (FAQ) that are posted on an IRS website for Form 1065 whose web address is referenced in both Notice 2019-66 and the new draft Schedule K-1. Of particular note, FAQ 6 provides an "outside basis" safe harbor which can be used to compute tax basis capital, provided that a statement is attached to the partner's Schedule K-1 with certain required information. However, complexities remain with respect to determining the scope of "tax basis capital," such as whether Code Section 743(b) adjustments should affect its computation. In Notice 2019-66, the IRS states that, in anticipation of the use of tax basis capital account reporting across the board for the 2020 taxable year, it will issue additional guidance, and seek further comment, regarding the definition of partner tax basis capital.

2. Solely for purposes of the requirement to report each partner's share of "net unrecognized Section 704(c) gain or loss," the IRS has defined this term as "the partner's share of the net (net means aggregate or sum) of all unrecognized gains or losses under [Code Section 704(c)] in partnership property, *including Section 704(c) gains and losses arising from revaluations of partnership property*" (emphasis added). The IRS's decision to keep this requirement effective for 2019 while also including the concept of partnership property revaluations may create difficulties for partnerships that have not consistently tracked Section 704(c)-relevant aspects of partnership book-ups and book-downs as new partners have been admitted or others have retired.
3. The IRS announced that reporting of "net unrecognized Section 704(c) gain or loss" will not apply to publicly traded partnerships ("PTPs"). Furthermore, the IRS noted that uncertainties with respect to the proper manner of reporting such amounts (e.g., uncertainties with regard to issues previously raised in Notice 2009-70) should be

resolved “in a reasonable manner” and in a way that is consistent with the application of Code Section 704(c) to partners in prior years.

4. The general requirement for separate reporting of detailed information regarding “Section 465 at-risk activities” was postponed until 2020, although the need to indicate whether activities have been aggregated for purposes of Code Section 465 still applies in 2019; in addition, the IRS noted that nothing in Notice 2019-66 affects partnerships’ and partners’ need to comply with any reporting of partnership activities on Form 6198, regarding At-Risk Limitations, for 2019.

Moreover, in Notice 2019-66, the Service granted relief from penalties for partners and partnerships that report 2019 items in a manner that is consistent with the notice. This relief extends to penalties for failing to furnish correct payee statements under Code Section 6722, for failing to file a partnership return showing the required information under Code Section 6698, or for failing to furnish information required on a Schedule K-1 (Code Section 8865) under Code Section 6038.

Conclusion

The IRS has provided welcome relief to partnerships and their partners in Notice 2019-66, although some may question whether it goes far enough. Continued monitoring of the foregoing issues will remain important as debates regarding the appropriate definition of “tax basis capital” and the proper scope of “net unrealized Section 704(c) gain or loss” take shape.

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