



October 28, 2022

Ms. Holly Porter  
Associate Chief Counsel  
Passthroughs & Special Industries  
Internal Revenue Service  
1111 Constitution Ave, NW  
Washington, DC 20224

Mr. Cliff Scherwinski  
Director  
LB&I Passthrough Entities Practice Area  
Internal Revenue Service  
1111 Constitution Ave, NW  
Washington, DC 20224

**RE: Form 1065, U.S. Return of Partnership Income, Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., and Related Instructions**

Dear Ms. Porter and Mr. Scherwinski:

The American Institute of CPAs (AICPA) is pleased to submit suggestions on the Form 1065, *U.S. Return of Partnership Income*, Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, and related instructions. Our suggestions include comments and recommendations for your consideration to further clarify the Form 1065, Schedule K-1 (Form 1065), and related instructions.

Our comments specifically address the following:

- I. Definition of Net Income (Loss)
- II. Section 465<sup>1</sup> At-Risk Reporting and Schedule K-1 Presentation
- III. Miscellaneous Additional Comments
  1. Schedule K-1, Box H2: Disregarded Entity Reporting
  2. Schedule K-1, Proposed Box O: Centralized Partnership Audit Regime Reporting
  3. Form 1065, Page 1, Box G: Check Applicable Boxes
  4. Section 1061 Reporting

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<sup>1</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (IRC or "Code"), as amended, or to the Treasury Regulations promulgated thereunder.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Jose Ramon Carrasco, Chair, AICPA Partnership Taxation Technical Resource Panel, at (202) 521-1552 or [Jose.Carrasco@us.gt.com](mailto:Jose.Carrasco@us.gt.com); Jon Williamson, AICPA Senior Manager – Tax Policy & Advocacy, at (216) 509-2972 or [Jon.Williamson@aicpa-cima.com](mailto:Jon.Williamson@aicpa-cima.com); or me at (601) 326-7119 or [JanLewis@HaddoxReid.com](mailto:JanLewis@HaddoxReid.com).

Sincerely,

A handwritten signature in cursive script, appearing to read "Jan Lewis", written in black ink.

Jan Lewis, CPA  
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, Internal Revenue Service  
Mr. William M. Paul, Principal Deputy Chief Counsel, Internal Revenue Service

## AMERICAN INSTITUTE OF CPAs

### **Form 1065, U.S. Return of Partnership Income, Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., and Related Instructions**

**October 28, 2022**

#### **I. Definition of Net Income (Loss)**

##### Overview

Different definitions of net income (loss) throughout Form 1065 and its related attachments and instructions creates uncertainty, unnecessary complexity, and inconsistent reporting among taxpayers.

*Page 5, Form 1065 net income (loss) – Analysis of Net Income (Loss), Schedule M-2, and Schedules M-1/M-3*

Page 5 of Form 1065 includes a section labeled “Analysis of Net Income (Loss).” Line 1 of this section instructs taxpayers to calculate net income (loss) by combining “Schedule K, lines 1 through 11. From the result, subtract the sum of Schedule K, lines 12 through 13d, and 21.” This definition of net income (loss) therefore includes certain partner level income and loss items, such as guaranteed payments (reported on Schedule K, line 4) and section 743(b) adjustments (reported on Schedule K, line 11 or line 13d). However, this definition of net income (loss) excludes tax-exempt income and nondeductible expenses (reported on Schedule K, line 18). This definition of net income (loss) is also used on Schedule M-1 and in Column (d) of Schedule M-3 to reflect net income (loss) after book to tax adjustments. In addition, the instructions for Schedule M-2 were changed from prior years where Schedule M-2 was simply an aggregation of the Schedules K-1. The 2021 Form 1065 instructions now state that Schedule M-2, line 3 (Net Income (Loss)) should be the amount from the Analysis of Net Income (Loss), line 1.

*Current year net income (loss) – Schedule K-1, Item L*

Beginning with tax year 2020, taxpayers are required to report capital accounts on Schedule K-1, item L using the tax basis method.<sup>1</sup> The 2021 instructions for line 3 (current year net income (loss)) specify: “On the line for current year net income (loss), enter the partner’s distributive share of partnership income and gain (including tax-exempt income) as figured for tax purposes for the year, minus the partner’s distributive share of partnership loss and deductions (including nondeductible, noncapital expenditures) as figured for tax purposes for the year.”

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<sup>1</sup> See 2020 Form 1065 Instructions.

## Recommendation

The AICPA recommends aligning the definitions of net income (loss) on Form 1065 and related forms and attachments to reduce reporting complexity for taxpayers and to help ensure consistent application across taxpayers.<sup>2</sup>

Alternatively, we suggest that the instructions clarify the various calculations on the Form 1065 and its related forms, schedules and attachments to assist taxpayers in better understanding the differences between the various definitions of net income (loss).

## Analysis

The inconsistent definitions of net income (loss) in various sections of the Form 1065 and accompanying schedules can be illustrated by reviewing the treatment of three specific items.

First, the instructions for Schedule K-1, item L state that “Section 743(b) basis adjustments are not taken into account in calculating a partner’s capital account under the tax basis method.”<sup>3</sup> While the instructions clarify that section 743(b) adjustments are not considered, it is not specifically stated whether the current year impact of section 743(b) adjustments should be included in the current year net income (loss) and removed elsewhere (e.g., as an “other increase (decrease)”) or simply excluded from current year net income (loss). The treatment of section 743(b) adjustments on Schedule K-1, item L should be specifically addressed. If the intent is to report the current year net income (loss) without the current year impact of section 743(b) adjustments, this would differ from the calculation of net income (loss) for purposes of the Analysis of Net Income, Schedule M-1, Schedule M-2, and Schedule M-3. The instructions to Schedule M-2 include section 743(b) adjustments in net income (loss) and instruct the partnership to make offsetting adjustments as other increases or decreases to remove the impact to each partner’s ending capital account balance.

Second, the treatment of guaranteed payments is similarly unclear for purposes of the tax basis capital reporting on Schedule K-1, item L. If a guaranteed payment is not treated as a distributive share of partnership income for tax capital reporting, then guaranteed payment income appears to be excluded in tax basis capital reporting.<sup>4</sup> This interpretation is consistent with the impact of guaranteed payments on capital accounts under the section 704 regulations, which state: “Guaranteed payments to a partner under section 707(c) cause the capital account of the recipient partner to be adjusted only to the extent of such partner’s distributive share of any partnership deduction, loss, or other downward capital account adjustment resulting from such payment.”<sup>5</sup>

However, to the extent guaranteed payments are treated as a distributive share of partnership income, guaranteed payments would be included in the calculation of tax capital and a

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<sup>2</sup> Appendix A contains specific proposed revisions for aligning the definition of net income (loss).

<sup>3</sup> See 2021 Form 1065 Instructions, page 31.

<sup>4</sup> See section 707(c). See also IRS Publication 541: “Guaranteed payments are those made by a partnership to a partner that are determined without regard to the partnership’s income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner. This treatment is for purposes of determining gross income and deductible business expenses only. For other tax purposes, guaranteed payments are treated as a partner’s distributive share of ordinary income.”

<sup>5</sup> Treas. Reg. § 1.704-1(b)(2)(iv)(o).

corresponding distribution would be necessary in order to report the correct ending tax capital. This approach would be inconsistent with the treatment of a guaranteed payment as a transaction between the partnership and a person who is not a partner<sup>6</sup> and the general thinking of most tax practitioners. However, without additional specific guidance, certain taxpayers may include the guaranteed payment income from line 4 of Schedule K-1 as a part of the tax basis capital reporting, while others may exclude the same payment.

While the treatment of guaranteed payments is not addressed in the instructions for Schedule K-1, item L, the instructions for Schedule M-2 state that guaranteed payments are not included in a partner's tax basis capital account. As such, it appears that the expected treatment of guaranteed payments is similar to section 743(b) adjustments resulting in the same questions as to how these amounts are to be reported on Schedule K-1, item L and whether that treatment is expected to be inconsistent with the Schedule M-2 reporting.

Third, the treatment of tax-exempt income and nondeductible expenditures is specifically addressed in the instructions for Schedule K-1, item L which state that such amounts should be included in the current year net income (loss). The Analysis of Net Income, Schedule M-1, Schedule M-2, and Schedule M-3, however, do not include such amounts in determining the net income (loss) and therefore there is a clear disconnect between Schedule K-1, item L and the other sections of Form 1065.

The inconsistent treatment of certain items between these calculations creates significant confusion for taxpayers and the instructions should be aligned to ensure consistent definitions where the calculations should be the same, and distinctly specify where certain amounts are to be calculated differently.

## **II. Section 465 At-Risk Reporting and Schedule K-1 Presentation**

### Overview

Schedule K-1, box 22 (added in tax year 2019) asks taxpayers to assert whether the partnership is engaged in more than one activity for at-risk purposes. However, the term “activity” is not defined in the Code or Regulations for purposes of the section 465 “at-risk” loss limitation rules.<sup>7</sup> In the limited guidance that does exist, the Internal Revenue Service (IRS) appears to adopt an excessively narrow and asset-specific definition of what constitutes an activity – “the smallest indivisible piece or parcel of property, business asset, or integrated business unit in which the taxpayer possesses an ownership interest.”<sup>8</sup>

The impact of this narrow and uncertain definition is further amplified by the extremely limited ability for many passthrough entities to aggregate activities. When uncertainty exists under the passive activity rules as to whether an activity represents one activity or several – the passthrough entity's ability to group serves as a backstop. This is not the case under the at-risk rules.

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<sup>6</sup> See section 707(a) and section 707(c).

<sup>7</sup> Compare section 469 “passive activity” loss limitation rules and associated guidance regime.

<sup>8</sup> See CCA 201805013.

Without additional regulatory guidance under section 465(c)(3)(C), aggregation is only available to a much smaller group of passthrough entities: those entities where 65 percent or more the entity's losses are allocable to an active participant.<sup>9</sup>

### Recommendations

The AICPA recommends the IRS issue guidance clarifying the definition of an activity under section 465, and the Department of the Treasury ("Treasury") observe the statutory mandate under section 465(c)(3)(C) by issuing regulations outlining aggregation rules that align with current economic passthrough entity business operations.

We also recommend that Treasury and IRS issue a notice or revenue ruling that provides taxpayers with a safe harbor aggregation methodology that allows taxpayers to utilize reasonable methods that align to the economics of their operations, specifically including methods similar to the section 469 grouping rules.

### Analysis

The issues regarding the current definition (in issued guidance) of an activity and associated grouping rules under section 465 are illustrated by the following example:

Partnership (or S Corporation) is owned at least 36 percent by passive investors, and it operates a distribution business.

As part of that business, the entity purchases equipment including trucks and forklifts. Each of these pieces of machinery is independently financed, and the terms of each note is nonrecourse for both section 1001 and section 752 purposes.

Under the current, narrow definition, "the smallest indivisible piece or parcel of property, business asset..."<sup>10</sup> appears to require that each truck and forklift is reported as a separate at-risk activity. As aggregation is not available to this passthrough entity,<sup>11</sup> each "activity" would need to be reported separately on Schedule K-1 footnotes provided to the partners (or shareholders).

The literal interpretation of the current guidance creates uncertainty for both taxpayers and the IRS. Reporting the smallest indivisible piece or parcel of property is extremely burdensome to taxpayers and the benefit provided to tax compliance and the general collection process is unclear.<sup>12</sup> Further, auditing such reporting without clear guidelines could lead to inconsistent treatment based on an exam team's interpretation of this guidance.

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<sup>9</sup> Section 465(c)(3)(B)(ii).

<sup>10</sup> CCA (n 8).

<sup>11</sup> This is due to the percentage of the passthrough entity's passive ownership under section 465(c)(3)(B)(ii).

<sup>12</sup> As a practical matter, the mechanical operation of the loss limitation rules (losses running through each limitation rule in a waterfall) would generally capture losses allowed as a result of section 465 aggregation under section 469 or section 461(l).

Additional practical issues arise such as: (1) the proposed allocation of revenue to each forklift; (2) the proper reporting and presentation of this allocation (of *each* individual activity); and (3) the proper reporting regarding overhead and maintenance expenses allocated to that activity.<sup>13</sup>

The AICPA notes that it is not uncommon for taxpayers to utilize the section 469 grouping rules for section 465 purposes notwithstanding the lack of specific guidance allowing for this approach. In many (but not all) cases, utilizing the section 469 grouping rules is economically warranted.

The burden of at-risk reporting is one of the many compliance issues that exist for passthrough entities. As a result of disparate regulations and regimes, a passthrough entity may be required to track separately its business activities under each of the following grouping and aggregation methodologies:

- Activity under the section 465 at-risk rules,
- Activity under the section 469 passive loss and credit rules,
- Trade or business under the section 199A rules, and
- Trade or business under the section 511-514 rules regarding unrelated business income.

Despite situations where a common grouping method is not possible due to variances in the relevant statutes, these situations are often limited. Therefore, an opportunity exists to establish a common safe harbor rule that could have broad applicability and reduce the compliance burden on both taxpayers and the IRS while streamlining (consistent) reporting.

### **III. Miscellaneous Additional Comments**

#### Overview

The following miscellaneous items are additional comments to consider when revising the forms and instructions for the 2022 tax year.

#### 1. Schedule K-1, Item H2: Disregarded Entity Reporting

#### Recommendation

The AICPA recommends the instructions clarify the disregarded entity (DE) reporting for partners holding an interest through multiple DEs.

#### Analysis

Schedule K-1, item H2 generally provides that if a partner is a DE, Schedule K-1 needs to include the name and TIN of the DE partner. There is uncertainty and inconsistent reporting where a partner owns its interest in the partnership through multiple DEs. IRS FAQs<sup>14</sup> provided guidance

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<sup>13</sup> The “slippery slope” regarding these issues creates absurd end results and reporting issues that are likely not intended (or were not) when issuing CCA 201805013.

<sup>14</sup> See [Clarifications for Disregarded Entity Reporting and section 743\(b\) Reporting](#) (Rev. Nov. 18, 2021).

in situations where a partner owns an interest through tiered DEs but did not provide guidance where a partner transfers an interest to a DE during the year, owns an interest both directly and through a DE, or through brother-sister DEs. Additional instructions and an example illustrating the appropriate reporting in this fact pattern would be helpful for taxpayers.

## 2. Schedule K-1, Proposed Item O: Centralized Partnership Audit Regime Reporting

### Recommendation

The AICPA recommends modifying Schedule K-1, by adding an additional centralized partnership audit regime (CPAR) reporting checkbox specifically to indicate whether the partnership has elected out of the CPAR.

### Analysis

Many otherwise eligible partnerships have not elected out of the CPAR.<sup>15</sup> The AICPA suspects this is due to both: (1) previous unfamiliarity with the election out procedures regarding those otherwise eligible partnerships; and (2) the election out process providing a trap for unwary. Adding a checkbox provides a “catch” mechanism for taxpayers and a flag for tax software to alert taxpayers of their potential eligibility to elect out of the CPAR.

As previously noted by the AICPA,<sup>16</sup> the CPAR is extraordinarily complex, and taxpayers (as well as the IRS) are adjusting to its practical mechanics. The consequences of missing the election could be significant for taxpayers. In light of this now inadvertently missed election, the taxpayer must now learn the intricacies of CPAR as filing an amended return is not available. This creates substantial burden for unaware taxpayers *and* the IRS when Congress has otherwise allowed these eligible partnerships to elect out and use the far more familiar amended return procedures.

## 3. Form 1065, Page 1, Item G: Check Applicable Boxes

### Recommendation

The AICPA recommends adding a checkbox indicating whether the partnership is a continuation of another partnership as well as a requirement to provide a brief description of the circumstances or transactions that resulted in the partnership being treated as a continuation partnership (e.g., partnership merger). Additionally, the AICPA recommends adding a checkbox specifically for continuing partnerships that indicates whether the continuing partnership is filing under a new employer identification number (EIN).

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<sup>15</sup> See, e.g., Taylor, “[Most Partnerships Are Staying in the Centralized Audit Regime](#),” 2021 TPR 29-2 (Jul. 19, 2021); Richman, “[IRS Sees Growing Interest in Partnership Audit Options](#),” 173 Tax Notes Federal 95 (Oct. 4, 2021).

<sup>16</sup> See AICPA letter, “[Changes to Simplify and Improve the AAR Process Under the Centralized Partnership Audit Regime and Proposed “AAR-EZ” Process Framework](#)” (May 25, 2021).



## Analysis

The AICPA appreciates the complexity in determining what constitutes a partnership continuation.<sup>17</sup> However, once a taxpayer *determines* that a continuation has occurred, these checkboxes provide practical and tangible benefits for tax compliance in lieu of the resource-intensive undertaking of *defining* a continuation. Providing these additional checkboxes would significantly improve the accuracy and completeness of partnership returns that have undergone complex partnership transactions.

The proposed “continuation” and “EIN” checkboxes provide both the IRS and tax preparers greater detail and insight into partnership historical transactions when reviewing prior year tax returns. The additional checkboxes should also improve the compliance burden on continuation partnerships by minimizing, or eliminating, the need to respond to IRS notices or otherwise contact the IRS to explain EIN changes resulting from a partnership transaction.

### 4. Section 1061 Reporting

## Recommendation

The AICPA recommends that certain clarifications be made to the amounts includable on lines 1 and 2 of Section 1061 Worksheet A (“Worksheet A”).

## Analysis

A pass-through entity that has issued an applicable partnership interest (API) to a partner is required to attach Worksheet A to that partner’s Schedule K-1 for any tax returns filed after December 31, 2021, if the pass-through entity is applying the final regulations. Worksheet A and its related instructions have been incorporated into Publication 541 as of March 2022. We appreciate the changes made in response to our prior comment letter on the section 1061 reporting FAQs.<sup>18</sup>

It appears that Worksheet A, line 1 is intended to include all long-term capital gains reported to the partner. The worksheet instructs the partnership to include: “Net long-term capital gain (loss) from Schedule K-1 (Form 1065), box 9a; Schedule K-1 (Form 1120-S), box 8a; or Schedule K-1 (Form 1041), box 4a.” Most partnerships will report long-term capital gains on Schedule K-1, line 9a, however, hedge funds that are in the trade or business of trading may report long-term capital gains elsewhere.<sup>19</sup> The AICPA recommends that line 1 include all long-term capital gains reported to the partner regardless of where the amounts are reported.

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<sup>17</sup> See, e.g., N.Y. State Bar Association, [Report No. 1432 – Report on Partnership Terminations Following the Tax Cuts and Jobs Act](#) (providing comprehensive comments on section 708 continuation issues) (Jan. 17, 2020).

<sup>18</sup> See AICPA letter, [“AICPA Comments on Section 1061 Reporting Guidance Frequently Asked Questions \(FAQs\)”](#) (December 23, 2021).

<sup>19</sup> A full discussion of the reasoning behind this reporting is outside the scope of this letter but because the income or loss from a trader fund’s trading activities is neither passive income nor is it portfolio income for purposes of the passive activity loss rules pursuant to Temp. Reg. §§ 1.469-1T(e)(6) and 1.469-2T(c)(3)(ii)(D), trader hedge funds frequently report items on Schedule K, Line 11, code I (Other income (loss)).

Worksheet A, line 2 instructs the partnership to include “Capital gains or (losses) **included in line 1** that are not subject to § 1061 under § 1.1061-4(b)(7).” The amounts not subject to section 1061 under Treas. Reg. § 1.1061-4(b)(7) include: section 1231 gains/losses, section 1256 gains/losses, qualified dividends, and certain gains and losses from mixed straddles. In general, none of these amounts are reported on Schedule K-1, line 9a and therefore, none would be included on Worksheet A, line 1. As such, Worksheet A, line 2 is likely zero for most, if not all, partnerships. The AICPA recommends no changes to line 2 but requests that the instructions make clear that the provision of Worksheet A satisfies the reporting requirements of Treas. Reg. § 1.1061-6(b)(1), including the requirement under Treas. Reg. § 1.1061-6(b)(1)(ii) to provide the amounts not subject to section 1061 under Treas. Reg. § 1.1061-4(b)(7). Alternatively, we would suggest an additional supplemental disclosure at the bottom of Worksheet A of the amounts not subject to section 1061 under Treas. Reg. § 1.1061-4(b)(7).

## ***Appendix A: Detailed List of Suggested Changes to Net Income (Loss) Calculations***

Form 1065, Page 5, Analysis of Net Income (Loss):

1. Remove guaranteed payments (line 4) and section 743(b) adjustments (line 11F or 13d) from the calculation of net income (loss).

Schedule M-1:

1. Remove line 3 to adjust for guaranteed payments. By removing guaranteed payment income from the Analysis of Net Income, it will no longer be necessary to add it back to arrive at partnership net income (loss). A deduction for a guaranteed payment will reduce partnership income, but the corresponding income will be treated as a partner level item.
2. Clarify that amounts attributable to section 743(b) adjustments should not be included in the calculation of net income (loss).

Schedule M-3:

1. Clarify that amounts attributable to section 743(b) adjustments should not be included in the calculation of net income (loss) per tax return in column (d) of Schedule M-3.

Schedule K-1, Item L:

1. Adjust the definition of current year net income (loss) to exclude tax-exempt income and nondeductible expenses.
2. Adjust the definition of other increase (decrease) to include tax-exempt income and nondeductible expenses.
3. Clarify that the definition of current year net income (loss) does not include guaranteed payment income from line 4 of Schedule K-1.
4. Clarify that the definition of current year net income (loss) does not include section 743(b) adjustments from line 11 code F or line 13 code V of Schedule K-1.

Schedule M-2:

1. Adjust the instructions of lines 4 and 7 for other increases and other decreases to include tax-exempt income and nondeductible expenses, respectively.