AICPA

September 15, 2020

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

RE: Notice 2020-43 – Tax Capital Reporting

Dear Ms. Porter:

The American Institute of CPAs (AICPA) appreciates the efforts of the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) in developing and issuing additional guidance concerning the tax capital reporting requirements. On June 5, 2020, the IRS issued Notice 2020-43 – Tax Capital Reporting ("the Notice"). These comments are in response to the request for comments on the two methods to calculate Tax Capital provided for in the Notice, and a request to add the Transactional Method[1] to allow flexibility for all partnerships.

Specifically, the AICPA provides our comments and recommendations on the following issues:

I. Provide the Underlying Purpose of the Tax Capital Reporting Requirement

II. Allow the Use of the Transactional Method
    1. Benefits of Transactional Method
    2. Transactional Method General Framework
        i. Transactional Method Approach to Determining Opening Tax Basis Capital Account Balances in Certain Cases
        ii. Transactional Method Approach with Respect to Certain Situations
        iii. Transactional Method Approach Where Specific Guidance is Not Provided
        iv. Naming Convention

III. Interaction with the Bipartisan Budget Act of 2015

IV. Modified Outside Basis Method
    1. Satisfying the Modified Outside Basis Method by Using a Combination of Amounts Provided by a Partner and Determined by the Partnership
    2. Written Notification Rule
    3. Section 705(b) Alternative Rule

[1] The Transactional Method and framework are defined in recommendation II.

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V. Modified Previously Taxed Capital Method
   1. Disposition of Interests
   2. Simplified Method for Allocating Fair Market Value to Assets

VI. Special Rule for Publicly Traded Partnerships

VII. Use of Alternative Methods to Compute Unrealized Section 704(c) Gains and Losses

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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 Sarah Allen-Anthony, Chair, AICPA Partnership Taxation Technical Resource Panel, at (547) 235-6818, or Sarah.Allen-Anthony@crowe.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204, or Alexander.Scott@aicpa-cima.com; or me at (612) 397-3071 or Chris.Hesse@CLAconnect.com.

Sincerely,

Christopher W. Hesse, CPA
Chair, AICPA Tax Executive Committee

cc: Mr. Samuel P. Starr, Special Counsel to the Associate Chief Counsel, Office of Associate Chief Counsel (Passthroughs & Special Industries), IRS
Ms. Holly Paz, Director, LB&I Passthrough Entities Practice Area, IRS

BACKGROUND

Partnerships have generally been required to report capital accounts for each partner on Item L of Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc*. Historically, partnerships have had the option of reporting partner capital accounts determined based on principles under Internal Revenue Code (IRC or "Code") section 704(b),[2] Generally Accepted Accounting Principles (GAAP), tax basis, or using some other method. To the extent partnerships computed and reported capital account balances on a tax basis (i.e., "tax basis capital accounts"), many have historically used a method that is substantially similar to what the Notice refers to as the Transactional Method.

The 2018 instructions to Form 1065, *U.S. Return of Partnership Income*, and Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc*., introduced a new partnership capital account reporting requirement for partnerships that did not otherwise report capital accounts on a tax basis. The new reporting requirement generally required partnerships to report tax basis capital accounts of partners that had a negative tax basis capital account balance as of the start or end of the tax year ("the Negative Tax Basis Capital Reporting Requirement").

On April 5, 2019, the IRS released Frequently Asked Questions (FAQs) explaining how partnerships should generally compute tax basis capital accounts for purposes of the Negative Tax Basis Capital Reporting Requirement. The FAQs included a safe harbor approach under which the tax basis capital account could be computed by subtracting a partner's allocable share of debt from the outside tax basis such partner had in its partnership interest.

On September 30, 2019, drafts of the 2019 Form 1065 were released that required partnerships to report capital accounts for all partners on a tax basis rather than for only partners with negative tax basis capital amounts as of the start or end of the tax year (the "Tax Capital Reporting Requirement").[3]

On December 11, 2019, the IRS released Notice 2019-66 providing that the Tax Capital Reporting Requirement would not be effective for the 2019 tax year (for partnership taxable years beginning in calendar year 2019) but would instead be effective beginning in the 2020 tax year (for partnership taxable years that begin on or after January 1, 2020). As a result, the tax basis capital account reporting requirement for the 2019 tax year was the same as the requirements for the 2018 tax year. Notice 2019-66 further provided that the IRS would issue additional guidance with respect to the definition of tax basis capital accounts for purposes of complying with the Tax Capital Reporting Requirement.

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[2] Unless otherwise indicated, references to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), and references to a "Treas. Reg. §" are to the Treasury regulations promulgated under the Code.

[3] Instructions to these draft forms were released October 29, 2019.

On June 5, 2020 the IRS released Notice 2020-43 requesting public comments on a proposed requirement for partnerships to use only one of two alternative methods, the Modified Outside Basis Method ("MOB Method") or the Modified Previously Taxed Capital Method ("MPTC Method"), to satisfy the Tax Capital Reporting Requirement for tax years ending on or after December 31, 2020. As a result, partnerships would no longer be permitted to compute tax basis capital accounts using the Transactional Method (as described in the Notice), a method that has historically been used by taxpayers for computing, maintaining, and reporting (if applicable) tax basis capital accounts.

I. Provide the Underlying Purpose of the Tax Capital Reporting Requirement

Overview

While the IRS has informally discussed the intended purpose of the Tax Capital Reporting Requirement on several occasions (i.e., why the IRS is requesting this data and its intended use), the IRS has not yet described the underlying purpose in any form of guidance. Based on prior guidance that has been released in the form of FAQs, as well as informal comments made by the IRS, it can be inferred that the underlying purpose of the Tax Capital Reporting Requirement is to enable the IRS to compute a proxy or estimate of a particular partner's outside tax basis which could then be analyzed as part of the IRS's audit procedures.

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance explicitly stating the underlying purpose of the Tax Capital Reporting Requirement.

Analysis

Our understanding[4] of the intent of the Tax Capital Reporting Requirement is that, by adding together a partner's tax basis capital account with such partner's allocable share of debt, the IRS could (i) arrive at a directional estimate of such partner's outside tax basis in a partnership; and (ii) identify potential issues related to partner specific computations that may be outside the scope of partnership reporting requirements (e.g., gain that should be recognized by a partner pursuant to section 731(a) resulting from a cash distribution in excess of such partner's outside tax basis).

As further discussed in the AICPA's recommendation to allow using the Transactional Method (recommendation II) for purposes of computing tax basis capital accounts, partnerships could use this reporting requirement as a guiding principle when determining how to compute the effect of a particular transaction or item on each respective partner's tax basis capital account calculated under the Transactional Method.

[4] The subsequent discussion in this comment letter assumes that the primary purpose for the reporting requirement and method(s) used to calculate tax basis capital is to approximate a partner's outside tax basis in a partnership.

II. Allow the Use of the Transactional Method

1. Benefits of Transactional Method

Overview

The Notice is helpful in many respects and reflects careful consideration of our prior comments[5] with respect to tax basis capital account reporting. Specifically, taxpayers will appreciate that the Notice provides both the MOB and MPTC Methods as alternative methods for computing tax basis capital accounts. However, partnerships that have historically tracked and reported tax basis capital accounts have likely used the Transactional Method. Generally, under the Transactional Method, a partner's tax basis capital account is: (i) increased by the amount of money and tax basis of property contributed by the partner to the partnership (less any liabilities assumed by the partnership or to which the property is subject) as well as allocations of income or gain made by the partnership to the partner; and (ii) decreased by the amount of money and tax basis of property distributed by the partnership to the partner (less any liabilities assumed by the partner or to which the property is subject) as well as allocations of loss or deduction made by the partnership to the partner.

Recommendations

The AICPA recommends that Treasury and the IRS issue guidance considering the Transactional Method a permissible method, subject to certain clarifications and modifications described herein, for purposes of the Tax Capital Reporting Requirement in addition to the MOB Method and MPTC Method. The AICPA recommends providing taxpayers the option of using any of these three prescribed methods.

Analysis

We have previously commented that the Transactional Approach has various uncertainties as to how certain transactions may affect tax basis capital accounts. We have also commented on the uncertainty and difficulties associated with computing tax basis capital accounts for which the partnership has not tracked or captured the relevant historical data to reconstruct tax basis capital accounts using the Transactional Method, or it would be impractical or overly burdensome to recreate tax basis capital accounts using the Transactional Method.

While the AICPA understands the IRS's concerns with the potential complexities of the Transactional Method, many taxpayers may prefer the Transactional Method given their historical use and familiarity of this method. Most tax return and workpaper software applications, for example, currently utilize the Transactional Method and are generally capable of automatically rolling forward tax basis capital accounts year over year based on the relevant input data from Schedule K-1. As a result, a permissible method for purposes of computing tax basis capital accounts should include the Transactional Method.

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[5] *See, e.g.,* AICPA Comment Letter on 2019 Form 1065 and Schedule K-1 (Form 1065).

With respect to the historical uncertainties previously mentioned, the AICPA agrees that these uncertainties have resulted or could have resulted in inconsistent reporting by partnerships under the Transactional Method. These uncertainties can largely be attributed to the fact that the concept of "Tax Basis Capital Account," unlike a partner's basis in a partnership interest,[6] section 704(b) capital accounts,[7] or share of previously taxed capital,[8] is not currently defined in the Code or Treasury Regulations. As a result, unlike the computations related to the three aforementioned concepts, there is not a formalized set of rules or procedures describing how to compute tax basis capital accounts in all cases, nor are there any general guiding principles describing what tax basis capital is ultimately intended to represent.[9] However, adopting the general framework described herein for purposes of computing tax basis capital accounts under the Transactional Method, coupled with specific approaches to certain situations, will address this historical void in guidance. This will result in the Transactional Method as a viable, consistent, and easily administrable method, thus benefiting both taxpayers and the IRS.

2. Transactional Method General Framework

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance providing for the adoption of a general framework, coupled with specific approaches to certain situations further described herein, for purposes of computing tax basis capital accounts under the Transactional Method. This general framework relies on the following two guiding principles:

1. Partnerships should only consider transactions and the resulting items of income, gain, deduction, loss, or basis adjustments that affect the common tax basis of the partnership (i.e., "inside tax basis") when computing tax basis capital accounts. Once a partnership has determined which transactions (and resulting items of income, gain, deduction, loss, or basis adjustments) are taken into account under this first guiding principle, the partnership must then apply the second guiding principle.

2. The AICPA's understanding of the underlying purpose of this reporting requirement is to enable the IRS to compute an estimate of a particular partner's outside tax basis. The sum of the tax basis capital accounts, considering debt allocation and remaining net section 743(b) adjustment, should result in a close, reasonable approximation of the sum of the partners' outside tax basis based on the particular set of facts and circumstances.

[6] Determination of the basis of a partner's interest in their partnership is determined by reference to section 705 and the regulations thereunder.
[7] Determination of a partner's section 704(b) capital account is determined by reference to section 704(b) and the regulations thereunder.
[8] The computation of previously taxed capital is described in Treas. Reg. § 1.743-1.
[9] This issue has largely gone undiscussed by practitioners as tax basis capital accounts are an informational item that have no effect on any partnership or partner computations. That is, tax basis capital accounts are not used by either the partnership or partners in any computation that determines the recognized income, gain, deduction or loss that by either the partner or partnership.

Analysis

1. *The computation of tax basis capital accounts should only consider transactions and the resulting items of income, gain, deduction, loss, or basis adjustments that affect the common tax basis of the partnership.*

By excluding partner specific items that have no effect on common partnership tax basis, the aggregate tax basis capital accounts of all partners, when added together with the partnership's debt, will generally equal or approximate the partnership's common tax basis in its assets (i.e., partnership inside tax basis).[10] Generally, the reconciliation of aggregate tax basis capital to the tax basis equity on the partnership's tax basis balance sheet is an important reconciliation tool for taxpayers. This first general guiding principle would result in the preparation of partnership tax returns in a manner that is more conducive to that reconciliation process which would result in greater reporting accuracy. It would also ensure preparation of tax returns in a more consistent manner, which would enable the IRS to utilize this reconciliation tool in its examination process.

Partnerships should report net taxable income or loss on Form 1065 consistent with the proposed "inside" approach to reporting tax basis capital. For example, guaranteed payment income is currently included in partnership net income on page 5 of the Form 1065. Guaranteed payment income often leads to confusion among tax preparers because this income is income to the recipient, not the partnership. As a result, under the current reporting, improper inclusion of guaranteed payment income in the tax basis capital accounts or section 704(b) capital accounts is more likely. Given our general recommendation of an "inside" approach to tax basis capital reporting, we also recommend exclusion of section 743(b) adjustments from partnership net income, consistent with the tax basis capital account approach under our proposed general framework.

A section 743(b) adjustment and the associated basis recovery is a partner specific item that does not affect the partnership's tax basis balance sheet. Tax basis capital accounts should not include the initial basis adjustment or the subsequent basis recovery in the tax basis capital accounts under this first guiding principle. While the AICPA appreciates the IRS's efforts to estimate a partner's outside tax basis, it is the AICPA's view that because separate reporting of the net remaining section 743(b) adjustment is already required on each partner's Schedule K-1, there is no need to include it in the tax basis capital accounts. It is important for taxpayers and tax preparers to distinguish between common partnership tax basis and partner specific basis adjustments. By excluding the section 743(b) adjustment from the tax basis capital accounts, the issue of improperly co-mingling common basis and partner specific basis items, which could lead to other reporting and computational errors, is avoided.

[10] See Appendix A, Situation 2 for discussion of the AICPA's suggested approach to remaining tax basis capital (positive or negative) of former partners. Those amounts would need to be taken into account in the reconciliation process described.

2. *Each respective partner should calculate tax basis capital accounts in such a way that, when a given partner's tax basis capital account is added together with both its debt allocation and remaining net section 743(b) adjustment, the total should result in a close, reasonable approximation of the partner's outside tax basis based on the particular set of facts and circumstances.*

This second guiding principle is based on the AICPA's understanding that the underlying purpose of this reporting requirement is to enable the IRS to compute an estimate of a particular partner's outside tax basis. In many cases, adding a partner's tax basis capital account as computed under the Transactional Method with a partner's share of debt and net remaining section 743(b) adjustment may equate to that partner's outside tax basis in the partnership. However, the AICPA recognizes this is not always the case. For example, if a partner purchased a partnership interest and the partnership did not have a section 754 election in place, the sum of the transferee partner's inherited tax basis capital account and such partner's allocation of debt is likely different from that particular partner's outside tax basis.[11] However, the result is not unreasonable, as it is not the partnership's responsibility to track or compute each partner's tax basis in the partnership. Rather, it is the responsibility of each partner to independently track and compute its basis in the partnership. Instructions for Form 1065 and related Schedule K-1 should explicitly state partners are not to use the reported tax basis capital account in determining their tax basis in their partnership interest. As previously discussed, the tax basis capital account is, at best, an informational item for potential use by the IRS to estimate a partner's outside tax basis or perform various other types of reconciliations and stress testing.

With respect to applying these guiding principles, the AICPA recommends a simple two-step process. Under the first step, the partnership must determine which transactions (and resulting items of income, gain, deduction, loss, or basis adjustments) to consider for purposes of computing tax basis capital accounts. In determining which items affect the partnership tax basis capital accounts, taxpayers should utilize the first guiding principle previously described (i.e., only such items that affect a partnership's tax basis equity on its tax basis balance sheet). Once the partnership has determined which transactions (and resulting items of income, gain, deduction, loss, or basis adjustments) are taken into account, the partnership must then determine how each of those transactions separately affects the tax basis capital accounts of each respective partner.

The second guiding principle should determine how each particular transaction affects the tax basis capital accounts of each partner. By applying this broadly defined framework, taxpayers will consistently compute and report tax basis capital accounts under the Transactional Method.

[11] Note, the MPTC Method as provided in the Notice would have a similar result in this fact pattern.

i. Transactional Method Approach to Determining Opening Tax Basis Capital Account Balances in Certain Cases

Recommendations

The AICPA recommends that Treasury and the IRS issue guidance providing that partnerships that choose the Transactional Method may use the MPTC Method to determine opening tax basis capital account balances for each partner, applying the Transactional Method prospectively.

In instances in which partnerships have not historically tracked tax basis capital accounts, the AICPA recommends these partnerships use the MPTC Method to compute the opening tax basis capital account balances for each partner, applying the Transactional Method prospectively.

Analysis

Using the MPTC method to initially calculate tax basis capital is consistent with the first guiding principle of our proposed general framework for computing tax basis capital under the Transactional Method. It utilizes a concept that is based on partnership common tax basis (i.e., "inside tax basis"), exclusive of partner specific basis adjustments or items. However, the AICPA recognizes that this approach is not in complete alignment with the second guiding principle of our proposed general framework for computing tax basis capital under the Transactional Method. However, the MPTC method is a reasonable approach for determining opening tax basis capital account balances when otherwise impractical. In many cases, computing tax basis capital accounts using the MPTC method is reasonably close to re-computation from the inception of the partnership using the Transactional Method. Since this issue is largely isolated to older existing partnerships, the issue should not preclude use of the Transactional Method for all partnerships.

Additionally, in instances where partnerships have historically tracked and reported tax basis capital accounts using the Transactional Method, and the partnership does not have any reason to believe that tax basis capital accounts have been prepared in a manner that is inconsistent with the recommended framework described herein, we recommend a safe harbor providing that those partnerships may rely on tax basis capital as historically computed.

ii. Transactional Method Approach with Respect to Certain Situations

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance with respect to the common and recurring situations described in Appendix A. The recommended outcome and analysis with respect to these common and recurring situations is described in Appendix A, and taxpayers should adjust tax basis capital accounts consistent with the recommended approaches in Appendix A.

Analysis

Historically, there has been a general lack of clarity as to: (i) whether to take into account certain transactions (and resulting items of income, gain, deduction, loss, or basis adjustments) when computing tax basis capital accounts; and (ii) how certain transactions (and resulting items of income, gain, deduction, loss, or basis adjustments) should affect the tax basis capital accounts of each respective partner. The lack of clarity is largely due to the undefined nature of tax basis capital as previously discussed. As a result, taxpayers have historically taken inconsistent approaches to certain situations and types of transactions (e.g., section 734 adjustments, transfers of partnership interests, and negative or positive ending tax basis capital accounts of former partners).

In order to provide clarity and allow for taxpayers to consistently compute tax basis capital under the Transactional Method in a manner that is consistent with our proposed general framework, the AICPA recommends that, with respect to the common and recurring situations described in Appendix A, taxpayers should adjust tax basis capital accounts consistent with the recommended approaches in Appendix A.

iii. Transactional Method Approach Where Specific Guidance is Not Provided

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance with respect to transactions not specifically addressed in Appendix A. Taxpayers should adjust tax basis capital accounts in a manner that is consistent with the principles described in our recommended general framework for computing tax basis capital under the Transactional Method.

Analysis

While we propose specific approaches to common and recurring transactions, given the informational nature of tax basis capital, it is both difficult and impractical to specifically address how each and every transaction should affect tax basis capital.

iv. Naming Convention

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance changing the term “Tax Basis Capital Account” to “Partner’s Estimated Share of Partnership Tax Basis Equity.”

Analysis

While the term “Tax Basis Capital Account” is used throughout this comment letter, it would helpful to adopt a different naming convention to clarify partners cannot and should not use the amounts reported to compute the tax basis in their partnership interest.

III. Interaction with the Bipartisan Budget Act of 2015

Overview

As a result of the changes in partnership audits under the Bipartisan Budget Act of 2015 (BBA),[12] adjustments made in a BBA partnership audit generally result in a partnership level tax liability on the amount of the imputed underpayment. This is calculated by applying a tax rate to the appropriately netted adjustments made to partnership-related items. As defined in section 6241(2)(B), a partnership-related item means: "(i) any item or amount with respect to the partnership (without regard to whether or not such item or amount appears on the partnership's return and including an imputed underpayment and any item or amount relating to any transaction with, basis in, or liability of, the partnership) *which is relevant (determined without regard to this subchapter) in determining the tax liability of any person under chapter 1*, and (ii) any partner's distributive share of any item or amount described in clause (i)" (emphasis added).

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance indicating that the Tax Capital Reporting Requirement is not considered a partnership-related item as defined in section 6241(2)(B). Any issues with the computation of tax basis capital uncovered in connection with an audit under the BBA should not result in an imputed underpayment.

Analysis

The use by the IRS of required reporting of tax basis capital accounts under the Notice as a tool to estimate a partner's outside basis in its partnership interest is understood. However, even if applied consistently, none of the methods provided will result in an accurate approximation of outside basis for all partners of all partnerships in all cases. Taxpayers may approximate outside tax basis by using the tax basis capital accounts, but computing the partner's tax basis by reference to tax basis capital accounts is not required or permitted in accordance with section 705.

As noted, partners and the IRS cannot use tax basis capital accounts to determine the taxability of transactions that require tax basis (e.g., sale or exchange of the partner's interest, a distribution, or loss limitations). Additionally, tax basis capital accounts are not relevant to determining the taxability of any item of distributive share reported on a partner's Schedule K-1. Accordingly, the tax basis capital reporting requirement is not relevant in determining the tax liability of any person, and therefore does not qualify as a partnership item under section 6241(2)(B). Further, because imputed underpayments are calculated based on adjustments to partnership-related items, any adjustment made to the tax basis capital of a partner as a result of an audit should not result in an imputed underpayment.

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[12] P.L. 114-74.

IV. Modified Outside Basis Method

Overview

The Notice states that a partnership may use the MOB Method to satisfy the Tax Capital Reporting Requirement. The amount resulting under the MOB Method should equal the partner's adjusted basis in its partnership interest ("outside basis") as determined under the principles and provisions of Subchapter K (including, for example, sections 705, 722, 733, and 742) and subtracting the partner's share of partnership liabilities under section 752. The partnership may either determine the amounts itself or be provided these amounts by its partners.

Under the Notice, a partner must notify a partnership that uses the MOB Method, in writing, of any changes to the partner's outside basis during each partnership taxable year other than changes attributable to contributions to and distributions from the partnership and the partner's share of income, gain, loss, or deduction that are otherwise reflected on the partnership's Schedule K-1 ("Written Notification Rule"). The written notification must be provided of such changes within thirty days or by the taxable year-end of the partnership, whichever is later ("Written Notification Rule Due Date").

A partnership is entitled to rely on information provided by a partner with respect to its outside basis unless the partnership has knowledge of facts indicating that the provided information is clearly erroneous.

1. Satisfying the Modified Outside Basis Method by Using a Combination of Amounts Provided by a Partner and Determined by the Partnership

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance allowing a partnership to apply the MOB Method using outside basis amounts provided by its partners and determining outside basis of partners that do not timely provide such amounts to the partnership.

Analysis

A partnership request could obtain outside basis information from most, but not all, partners. The Notice indicates that "a partnership may satisfy the Tax Capital Reporting Requirement by determining, *or* being provided by its partners" (emphasis added) the partner's outside basis reduced by the partner's share of partnership liabilities under section 752. The language provides that a partnership may obtain a partner's outside basis from the partners or calculate the amounts itself. Some partnerships could receive outside basis information from some partners, but could have other partners that cannot easily, or are unwilling to, produce outside basis information.[13] For example, a partner that has not received any distributions or sold any portion of its interest may not have yet needed to determine its outside basis.

[13] In some instances a partner may not have its outside basis readily available or computed. Treasury Reg. § 1.705-1(a)(1) states that "a partner is required to determine the adjusted basis of his interest in a partnership only when necessary for the determination of his tax liability or that of any other person" (emphasis added).

If the partnership is able to compute such partner's outside basis using the historical Schedule K-1 and applying any other provisions of Subchapter K to considering any transactions of which the partnership has knowledge, the guidance should allow the partnership to use a combination of the computed amount for that partner and the outside basis amounts provided by the other partners.

2. Written Notification Rule

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance stating that the Written Notification Rule should be applied in a manner consistent with Treas. Reg. § 1.743-1(k)(2).

Analysis

Guidance is needed to address situations where a partner has not timely notified the partnership of an event that would affect its outside basis. Guidance should follow procedures similar to those found in section 743(b) for purposes of the MOB Method.

The regulations under section 743(b) similarly require a transferee partner that has acquired an interest in a partnership by sale or exchange to notify the partnership, in writing, within 30 days of the sale or exchange.[14] A partnership is not required to compute or report the adjustment under section 743(b) with respect to a transfer until it is notified of the transfer.[15] If the transferee fails to properly notify the partnership of the transfer, the partnership is entitled to report the transferee's share of partnership items without reflecting a basis adjustment.[16] If the transferee later provides the appropriate written notification to the partnership, the partnership can make the adjustments necessary to reflect the section 743(b) adjustment in either an amended return or in its next annual partnership return to be regularly filed.[17]

If a partner informs the partnership of an event affecting its outside basis after the Written Notification Rule Due Date, guidance should allow the partnership to make and report any required adjustments to the partner's outside basis on the partnership return for the taxable year immediately after the one that includes the Written Notification Rule Due Date. For example, if a calendar-year partnership is notified on April 30, 2020 by a partner about a change to its outside basis that occurred on June 30, 2019, the partnership would reflect the effects of the change on its partnership return for the year ended December 31, 2020.

Additionally, a change in a partner's outside basis should not require a partnership to amend its return or file an Administrative Adjustment Request.

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[14] Treas. Reg. § 1.743-1(k)(2).
[15] Treas. Reg. § 1.743-1(k)(4). For these purposes, the partnership is notified of a transfer when: (i) the transferee provides the required written notification; or (ii) any partner responsible for the federal income tax reporting of the partnership has knowledge of the transfer.
[16] Treas. Reg. § 1.743-1(k)(5).
[17] Treas. Reg. § 1.743-1(k)(5).

3. Section 705(b) Alternative Rule

Recommendation

The AICPA recommends that Treasury and the IRS provide guidance clarifying that a partnership can use the Alternative Rule in section 705(b) if the partnership is not able to practically apply the general rules to determine outside basis found in section 705(a).

Analysis

Section 705(b) provides Treasury the authority to provide the circumstances via regulations for determining a partner's outside basis by reference to its proportionate share of the adjusted basis of partnership property upon a termination of the partnership ("Alternative Rule"). The regulations allow the use of the Alternative Rule in two situations:

1. A partner cannot practicably apply the general rule set forth under section 705(a); or
2. The amounts resulting under the Alternative Rule will not vary substantially from the result obtained under section 705(a), in the opinion of the Commissioner of Internal Revenue ("the Commissioner").[18]

Partnerships that have been in existence for several years seemingly fit into the first category. A partnership can use the Alternative Rule by determining the aggregate basis of its partnership assets (perhaps by preparing a tax basis balance sheet) and multiplying it by the percentage that reflects the partner's liquidation right. The relevant facts and circumstances would determine the liquidation right percentage. Adjustments are required to reflect any discrepancies that would arise from using a partner's liquidation right percentage due to, for example, contributed property, transfers of partnership interests, or distributions of property to the partners.[19]

Example

A contributes land with an adjusted basis of $1,000 and a fair market value of $5,000 and B contributes cash of $5,000 each in exchange for a one-half interest in newly formed partnership, AB. Under the Alternative Rule, A's one-half share of the aggregate initial basis of the partnership assets ($6,000) is $3,000, which exceeds the basis of A's contributed property by $2,000. Thus, a reduction of $2,000 is needed to arrive at A's outside basis of $1,000. Several years later, AB's tax basis balance sheet is as follows:

	Tax
Cash	10,000
Receivable	30,000
Land	50,000
Total Assets	90,000

[18] Treas. Reg. § 1.705-1(b).
[19] Treas. Reg. § 1.705-1(b).

Liabilities	20,000
Capital	70,000

> If there have been no transfers of interest and AB continues to own the land contributed by A, A's one-half share of the aggregate inside basis is $45,000. The same $2,000 reduction related to the formation of the partnership must be applied to result in A's outside basis of $43,000. Assuming the liabilities are allocated equally between A and B under section 752, AB would report $33,000 to satisfy the Tax Capital Reporting Requirement for A.

Clarifying that the Alternative Rule is permissible to satisfy the MOB Method would provide a practical approach for partnerships to determine and provide the IRS outside basis or at least a proxy to outside basis.

V. Modified Previously Taxed Capital Method

Overview

While many partnerships will choose the Transactional Method (using the MPTC method only to compute opening balances when needed) for purposes of satisfying the Tax Capital Reporting Requirement, some partnerships may prefer to use the MPTC method to annually report tax basis capital accounts. As a result, additional guidance is necessary when using this method in certain situations.

1. Disposition of Interests

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance on reporting tax basis capital accounts under the MPTC method when partners have disposed of their interests (e.g., via a sale of interest or redemption).

Analysis

Additional guidance is necessary under the MPTC method in situations where a partner has disposed of 100% of its interest (e.g., via a sale, transfer, or redemption). It is currently unclear whether the partnership would report an ending tax basis capital account of zero for the exiting partner under the MPTC Method, or if the partnership should report the exiting partner's tax basis capital account immediately prior to the event.

2. Simplified Method for Allocating Fair Market Value to Assets

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance providing a simplified method for purposes of allocating estimated fair market value to the underlying assets or asset classes.

Analysis

Additional guidance is also needed when the partnership uses estimated fair market value for purposes of determining hypothetical gain or loss under the MPTC method. The estimated fair market value is likely the most appropriate value to compute hypothetical gain or loss. However, taxpayers may choose not to use estimated fair market value as it is often not readily available on an asset-by-asset basis. Partnerships often have an overall estimated fair market value of the business, but do not have the estimated fair market value of each particular asset. When the overall estimated fair market value of the partnership is known, but the partnership lacks the estimated fair market value on an asset-by-asset basis, the AICPA recommends that the IRS provide a simplified method for purposes of allocating estimated fair market value to the underlying assets or asset classes. For example, the method could allow taxpayers to allocate fair market value to each of the assets based on relative GAAP, section 704(b), or tax basis.

VI. Special Rule for Publicly Traded Partnerships

Overview

Many partnerships treated as publicly traded partnerships (PTPs) within the meaning of section 7704(b) currently track tax basis capital accounts using broker data and information provided to the PTP[20] to determine the initial outside basis of each new partner's interest in the PTP in the case of an acquisition of an interest in the PTP. This amount is rolled forward under the Transactional Method.

Recommendation

The AICPA recommends that, in addition to the other methods, Treasury and the IRS provide guidance allowing PTPs to use a combination of the Transactional Method and MOB Method. This modification for PTPs should allow PTPs to apply the principles of the MOB Method to information partners are already required to provide to the PTP[21] instead of requiring the PTP partners to provide any separate written notification to the PTP.

Analysis

PTPs generally make adjustments to tax basis capital accounts in the case of sales or exchanges of interests in the PTP (e.g., to reflect a transferee's purchase price of an interest in the PTP) rather than providing that a transferee is the successor to the tax basis capital account of a transferor under the Transactional Method approach recommended above. Therefore, many PTPs use a method viewed as a combination of both the Transactional Method and the MOB Method. PTPs adjust the tax basis capital account of a transferee partner based on an estimate of outside basis

[20] Under Treas. Reg. § 1.6031(c)-1T(a).
[21] *See* Treas. Reg. § 1.6031(a)-1T.

computed from broker data and market price data provided to the PTP. Written notification is not an administrable approach for PTPs.[22]

VII. Use of Alternative Methods to Compute Unrealized Section 704(c) Gains and Losses

Overview

Lack of historical data not only affects tax basis capital reporting, but may also affect a partnership's ability to report section 704(c) amounts. This effect is particularly true for taxpayers that inadvertently overlooked or misunderstood the effect of "reverse" layers created when cash is contributed to a partnership. These new reporting rules highlight these issues on a prospective basis. However, many taxpayers lack the data to complete a full computation of these amounts.

Recommendation

The AICPA recommends that Treasury and the IRS issue guidance that allows a taxpayer to meet the reporting requirements related to unrealized section 704(c) gains or losses by reporting the current variance between their section 704(b) capital and their tax basis capital as computed under either the Transactional Method, MOB Method, or MPTC Method, discussed above.

Analysis

A historical analysis of section 704(c) attributes is very similar to an historical analysis of tax basis capital under the Transactional Method and has the same limits. As a result, many taxpayers that were otherwise eligible to defer reporting of tax basis capital will nonetheless calculate and report these amounts to meet the section 704(c) reporting requirements that were not delayed. However, many taxpayers lack the required information to do so.

In many situations, computing a taxpayer's unrecognized section 704(c) amounts is a function of the variance between its section 704(b) and tax basis capital amounts. While this simplified method may have its limits, such as implications of the "ceiling" rule, those same issues are inherent in the alternative tax basis capital computation methods as well.

[22] Computing tax basis capital accounts in this manner might be described as "outside tax basis capital" because it will generally agree to outside basis less section 752 liabilities. However, this method will not agree to inside tax basis capital on the tax basis balance sheet of the partnership as under our suggested clarification of the Transactional Method discussed above.

Appendix A

Situation 1. Section 734 adjustments increase or decrease the tax basis capital account of the partner who engaged in the transaction that resulted in the section 734 adjustment.

Under the first guiding principle, a section 734(b) basis adjustment affects a partnership's inside tax basis in its assets. Accordingly, partnerships should reflect section 734(b) basis adjustments an adjustment to inside tax capital under the Transactional Method. Further, recognizing that the intention of the tax basis capital reporting requirement is to approximate a partner's outside tax basis, adjustments made under section 734(b) should affect the tax basis capital accounts of each partner in a manner that as closely as possible reflects how the partner's outside tax basis is affected by a transaction under the second guiding principle. Accordingly, section 734(b) adjustments should generally increase or decrease the tax basis capital account of the partner who engaged in the transaction that resulted in the adjustment.

Example:

Partnership AB has two equal partners, each with $200 of outside basis in its partnership interest. At a time when the tax basis of the partnership's assets is $600 and the fair market value of the partnership's assets is $800, Partner A receives a distribution of $300 in cash. Partner A recognizes gain under section 731(a) of $100 on the distribution and has outside basis of $0 in its partnership interest after the distribution. As Partnership AB has a section 754 election in place, the partnership's remaining assets receive a section 734(b) adjustment of $100.[23]

Partnership AB uses the Transactional Method to calculate tax basis capital accounts. The partners' tax basis capital accounts are calculated as follows:

	Partner A	Partner B
Beginning Tax Basis Capital	$200	$200
Distributions	($300)	$0
Section 734(b) Adjustment	$100	$0
Ending Tax Basis Capital	$0	$200
Ending Outside Tax Basis	$0	$200

Absent the inclusion of the section 734(b) adjustment in Partner A's tax basis capital in the example, a disparity is created between Partner A's outside tax basis and Partner A's tax basis capital account. Further, while the rules under section 704(b) dictate sharing that section 734(b) adjustments among partner capital accounts in the same manner as the gain that is displaced by the adjustment,[24] if any portion of the section 734(b) adjustment were allocated to Partner B tax basis capital account, it would create a disparity between Partner B's outside tax basis, which is unaffected by the transaction, and Partner B's tax basis capital account. Accordingly, in order for

[23] Note that the result of this example is unchanged if, instead of distributing cash, the partnership distributed an asset to Partner A with basis of $300. The partner would take basis in the asset of $200 under section 732 and would have $0 of remaining outside basis in their partnership interest. The partnership would still have a section 734(b) adjustment of $100, which would need to be allocated to Partner A in order to align tax basis capital with outside tax basis.
[24] *See* Treas. Reg. § 1.704-1(b)(2)(iv)(m)(4).

each partner's tax basis capital account to result in the closest approximation of each partner's outside tax basis as reasonably possible based on the particular set of facts and circumstances, allocation of the section 734(b) adjustment to the tax basis capital account of the partner who engaged in the transaction that triggered the adjustment is necessary.

Situation 2. Any remaining tax basis capital (positive or negative) in a partner's tax basis capital account after a full redemption from the partnership is not allocated to the remaining partners in the partnership.

In the case of a partnership without an election under section 754 in effect, the full redemption of a partner does not necessarily result in a section 734 adjustment.[25] Instead, there will be a disparity between the partnership's basis in its assets and the remaining partners' outside basis in their partnership interests. As the first guiding principle dictates, the distribution reduces the inside tax basis in the partnership's assets, and so should affect partner capital accounts. In keeping with the goal of providing the IRS with an estimate of outside tax basis through the tax basis capital reporting requirement, a partnership using the Transactional Method should not adjust the tax basis capital accounts of any partner for any remaining tax basis capital account (positive or negative) of a partner that is fully redeemed, because the remaining partners' outside basis is not affected by the transaction. Instead, the remaining capital account balance is included as an adjustment in the reconciliation of the partnership's tax basis in its assets and the remaining partners' tax basis capital accounts.

Example:

Partnership ABC has three equal partners, each with $200 of outside basis in its partnership interest. At a time where the tax basis of the partnership's assets is $600 and the fair market value of the partnership's assets is $900, Partner A receives a cash distribution of $300 in full redemption of its partnership interest. Partnership ABC does not have a section 754 election in place.

Partnership ABC uses the Transactional Method to calculate tax basis capital accounts. The partners' tax basis capital accounts are calculated as follows:

	Partner A	Partner B	Partner C
Beginning Tax Basis Capital	$200	$200	$200
Distributions	($300)	$0	$0
Ending Tax Basis Capital	($100)	$200	$200
Ending Outside Tax Basis	N/A	$200	$200

After the distribution, Partnership ABC has $300 of basis in its remaining assets. However, Partners B and C each have $200 of outside basis in their partnership interest. If Partner A's negative tax basis capital were allocated to Partner B and C's tax basis capital account, the result is a distortion of their tax basis capital accounts such that they are no longer aligned with their outside tax basis. In addition, if an adjustment were made to Partner A's capital account to bring

[25] A section 734(b) adjustment may still be required if the redemption results in a substantial basis reduction under section 734(d).

the capital account to zero, the data would not be useful to the IRS in identifying transactions that may result in gain on a full liquidation of the partner's interest.[26] Accordingly, no adjustment should be made to any partner's capital account for the remaining tax basis capital account subsequent to the full redemption of a partner's interest in the partnership.[27]

Situation 3. In the case of a sale or exchange of an interest in a partnership, the transferee partner steps in the shoes of the tax basis capital account of the transferor partner under the Transactional Method.

Many partnerships that have historically tracked tax basis capital accounts under the Transactional Method have assumed that the transferee partner "steps into the shoes" of the tax basis capital account of the transferor partner in the case of the sale or exchange of a partnership interest. That is, the tax basis capital account of the transferor partner would carry over to the transferee partner, and the transferee partner's inherited tax basis capital account is not adjusted to include a section 743(b) adjustment if the partnership had a section 754 election in place, nor would it be adjusted to reflect the transferee partner's outside tax basis in their partnership interest. This approach is consistent with the first guiding principle of our proposed general framework for computing tax basis capital under the Transactional Method, as this approach results in the aggregate tax basis capital accounts of the partners agreeing to the tax basis capital on the tax basis balance sheet of the partnership (i.e., "inside tax basis capital").

In the case of partnerships making section 743(b) adjustments with respect to sales or exchanges of interests in the partnership, these adjustments are basis adjustments solely with respect to the transferee partner. As a result, partnerships should exclude section 743(b) basis adjustments, and the related recovery of section 743(b) adjustments, from the tax basis capital accounts based on the first guiding principle of our proposed general framework (i.e., they should be excluded as they do not affect the inside tax basis of the partnership). This ensures that the aggregate tax basis capital accounts of the partners mirrors inside tax basis capital on the partnership's tax basis balance sheet.[28]

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[26] The instructions for Form 1065 require that Schedule M-2 (Form 1065), *Analysis of Partners' Capital Accounts*, reflects the totals of the amounts reported on Item L of each partner's Schedule K-1. Because a fully redeemed partner will report an ending tax basis capital in the year of redemption, the Schedule M-2 will include this "hanging capital account." In the succeeding year, the redeemed partner will no longer receive a Schedule K-1 and an adjustment to the beginning capital on Schedule M-2 is necessary to reconcile aggregate tax basis capital as reported on Schedule M-2 to the aggregate tax basis capital as reported on Schedules K-1 of the remaining partners.

[27] From a balance sheet tracking perspective, this methodology will create a situation where the total tax basis capital accounts of all remaining partners plus liabilities will not equal the total tax basis of the partnership's assets. However, in a situation where no section 754 election is in effect, the same issue would exist in comparing outside basis of the partners to the inside basis of the partnership's assets. As the tax basis capital reporting is designed as an estimate of outside basis, this result is appropriate. It is assumed that tax preparers would separately track the remaining tax basis capital accounts of former partners for reconciliation purposes.

[28] As of the date of this letter, the Form 1065 FAQ webpage provides that tax basis capital accounts include section 743(b) adjustments (FAQ 2(A)(v), FAQ 2(B)(vii), and FAQ 5). However, most partnerships that have historically tracked inside tax basis capital accounts under the Transactional Method have not followed the FAQ approach because this approach would not result in aggregate tax basis capital accounts agreeing to the tax basis equity of the partnership's tax basis balance sheet.

With respect to partial sales or exchanges, taxpayers have taken different approaches to determining what portion of tax basis capital to transfer in connection with the transaction depending upon the particular facts and circumstances. In a simple partnership that does not have any section 704(c) property, the analysis is straightforward. However, many partnerships do have section 704(c) property. Instead of prescribing a specific approach to partial exchanges, the AICPA recommends that taxpayers take an approach that is consistent with the general framework provided herein, taking into account the all of the facts and circumstances of a particular transaction.

In summary, the AICPA recommends the following when tax basis capital accounts are computed under the Transactional Method and there is a sale or exchange of an interest in the partnership: (i) in the case of a sale or exchange of 100% of an interest, the transferee partner "steps into the shoes" of the tax basis capital account of the transferor; (ii) section 743(b) adjustments (both the initial adjustment to partnership property and subsequent recovery) are excluded from tax basis capital accounts;[29] and (iii) in the case of partial exchanges, the amount of tax capital transferred by the transferor partner is consistent with the guiding principles of the general framework described herein.

Example:

Assume A and B formed AB LLC by each contributing \$100, and AB LLC used the \$200 to acquire stock in a corporation. Assume that AB LLC had no net taxable income, but its stock investment increased in value to \$240, and A sold its interest to C for \$120. C would have \$120 of outside basis and a \$20 section 743(b) adjustment (\$120 outside basis minus \$100 share of inside basis under Treas. Reg. § 1.743-1(d)(1)).

The partnership's tax basis balance sheet would reflect \$200 of assets, no liabilities, and \$200 of capital (\$100 for B and \$100 for C). Excluding the section 743(b) adjustment ensures that the aggregate tax basis capital accounts of the partners agrees to the inside tax basis capital on the partnership's tax basis balance sheet.

[29] While we recognize this approach is different than the FAQ computation, a partner's remaining section 743(b) adjustment is already separately disclosed on Line 20AH of Schedule K-1.