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IRS Requires Reporting of Tax Basis Capital Accounts

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The concept of a "tax basis capital account" is important in determining a partner's gain or loss from the sale of his partnership interest and from certain other partnership transactions. However, for tax years prior to 2020, tax basis capital accounts generally did not need to be disclosed on a partnership's income tax returns; instead, a partnership was permitted to report its partners' capital accounts on some other basis, such as GAAP or so-called "section 704(b)" capital accounts. These other methods were often of limited use to the IRS in identifying potentially taxable situations; thus, for taxable years ending on or after Dec. 31, 2020, partnerships are now required to report each partner's capital account on a tax basis.

A partner's tax basis capital account balance is generally equal to the amount of cash and tax basis of property contributed by the partner to the partnership, increased by allocations of taxable income to the partner, decreased by allocations of taxable loss to the partner, and decreased by the amount of cash or the tax basis of property distributed by the partnership to the partner.

A partner's tax basis capital account is also decreased by any liabilities of the partner that are assumed by the partnership and increased by any liabilities of the partnership that are assumed by the partner. If a partnership had not previously reported its partners' tax basis capital accounts and does not have sufficient records to do so, then the instructions to Form 1065 now provide that, for 2020 only, a partnership may use certain alternative methods to estimate its partners' tax basis capital accounts.

It appears that one of the main impetuses behind these reporting changes is to assist the IRS in determining whether a partner has a negative tax basis capital account. Generally, a partner with a negative tax basis capital account is allocated liabilities from a partnership in excess of his tax basis in his partnership interest. A partner can have a negative tax basis capital account to the extent that he has received a tax benefit in excess of his net investment in the partnership, determined on a tax basis. For example, a partner may have a negative tax basis capital account in a partnership if he received a tax-free distribution of financing proceeds in excess of his net investment in the partnership, or if he was allocated losses by a partnership in excess of his net investment in the partnership.

Having a negative tax basis capital account in a partnership has important income tax implications. First, a partner's gain from the sale of his partnership interest is generally equal to the cash he receives minus his tax basis capital account balance. If a partner has a negative tax basis capital account, then the gain from the sale of his partnership interest will generally exceed the cash he receives, and it is possible that the income tax attributable to the sale of the partnership interest could exceed the cash the partner receives from the sale.

Second, a partner's negative tax basis capital account must be supported by an allocation of partnership liabilities to the partner. If something changes such that the partner's share of partnership liabilities is smaller than his negative tax basis capital account, then the partner will recognize taxable income as a deemed distribution in excess of his tax basis. Generally, if a partnership liability is considered nonrecourse, then the partnership will allocate the liability to its partners in accordance with their profits interests (subject to certain rules designed to ensure that a partner that contributes property to a partnership subject to debt in excess of the property's tax basis receives sufficient allocations of that debt).

In contrast, if a partnership liability is considered to be recourse (i.e., a liability for which at least one partner bears the economic risk of loss), then the liability will be allocated to the partner who bears the economic risk of loss with respect to the liability. A partner may be treated as bearing the economic risk of loss with respect to a partnership liability, if for example, he lent money to the partnership or he has guaranteed third-party debt.

Thus, under these allocation rules, there are a variety of circumstances in which a partner's share of a partnership liability could change, such as if a partnership repays debt, if a partner guarantees partnership debt (or is removed from such a guarantee), or if third-party debt is refinanced with a partner loan (or vice versa). Partners with negative tax basis capital accounts must therefore pay close attention to partnership transactions, particularly those involving debt, to ensure that they do not unexpectedly recognize taxable income.

In sum, the new 2020 partnership tax basis capital account reporting requirements give the IRS much more visibility into the tax situations of partners in partnerships. Partners with negative tax basis capital accounts should expect increased IRS scrutiny, and should be particularly cautious of transactions that might decrease their shares of partnership liabilities.

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