July 31, 2020

The Honorable Charles P. Rettig
Commissioner of Internal Revenue
Internal Revenue Service
CC:PA:LPD (Notice 2020-43)
Room 5207, PO Box 7604
Ben Franklin Station
Washington, DC 20224

RE: Notice 2020-43 Comments on Tax Capital Reporting

Dear Commissioner Rettig:

The Texas Society of Certified Public Accountants (TXCPA) is a nonprofit, voluntary professional organization representing more than 28,000 members. One of the expressed goals of the TXCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of CPAs in Texas, as well as the public interest. TXCPA has established a Federal Tax Policy Committee to represent those interests on tax-related matters. The committee has been authorized by the TXCPA Board of Directors to submit comments on such matters of interest to the committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TXCPA.

Comments

We write in response to a request for comments on the tax capital reporting requirements in IRS Notice 2020-43. In a letter dated July 29, 2019 (copy attached), we commented on the administrative burdens associated with the new tax capital reporting requirements that appeared in the draft instructions for IRS Form 1065. We appreciate that you deferred implementation of those requirements and are continuing to consider this issue, including taking public comments, as we suggested. In general, we continue to see compliance concerns with the approach taken by the IRS in Notice 2020-43 and offer these comments to the specific requests of the IRS in the notice as well as some additional comments we believe would be helpful in your consideration.

Among other concerns more fully discussed below, we believe compliance with a burdensome new set of tax capital reporting rules should be deferred during the coronavirus pandemic because it adds to the costs and burdens of businesses and to the stresses on overburdened advisors as we are all trying to recover from the economic fallout of the ongoing crisis.

1. Whether the methods used to satisfy the tax capital reporting requirement described in Section III of this notice should be modified or adopted?

Given the significant change reflected by the two proposed methods in Notice 2020-43 (modified outside basis method and modified previously taxed capital method), we recommend as an initial matter – and as a matter of transparency – providing taxpayers with an explanation as to why long-standing approaches for computing partner capital accounts approved by the IRS should be changed now and what the IRS seeks to accomplish. The

two alternative approaches proposed by the IRS reflect a dramatic change to the traditional methods widely used and relied on by partnerships to account for partners' capital accounts and expressly approved by the IRS. These methods seem to have been workable to date and are based on information universally available at the entity level. The changes proposed in Notice 2020-43 would require significant modifications to the accounting systems and type of information gathered by millions of partnerships. In addition, requiring partners to report to partnerships what is essentially personal and confidential information may well require amendment of millions of partnership agreements. The IRS does not explain what has changed that would compel such a significant shift in policy or what the IRS seeks to accomplish. Without this information, practitioners are limited in their ability to provide meaningful input to the suggested approaches.

Although we cannot be certain, we perceive the IRS' concerns to be the following:

- Partners may not properly report distributions in excess of tax basis.
- Partners may not properly report losses for which they do not have tax basis.
- Partners may not properly report gains from dispositions of partnership interests.
- The IRS wants to reduce the potential burden of auditing individual partner returns.

To the extent these concerns are in fact driving the change in policy, none of these are new. We find it difficult to understand how the rules that have been in place for a very long time are just now proving unworkable to address these issues. Moreover, the potential misreporting issues identified above, whether witting or unwitting, all occur at the partner level – not at the partnership level. The partnership has no control over the reporting once the partnership tax return is filed. Therefore, any changes in reporting methodology to address these concerns should be focused at the partner level.

Furthermore, if the IRS is in fact concerned about the burden of auditing many individual partners' returns, we would suggest simply requiring partners to make disclosures that would identify problem situations; e.g., whether the partner received distributions or losses in excess of basis or capital accounts. Although this may be a burden on some taxpayers, it would more specifically target potential problem returns. But shifting the onus of effectively computing and reporting partner-level basis information to partnerships on matters that are largely unique to individual partners and adding the corresponding additional accounting and duplicative burden associated with compiling this information on a historical basis, when such information may simply not be available, sweeps much too broadly.

Keeping the basis reporting requirements at the partner level is consistent with how these same concerns are addressed for S Corporation shareholders. Schedule E to IRS Form 1040 requires S corporation shareholders to attach a basis computation if they report a loss, receive a distribution, dispose of stock or receive a loan repayment from an S Corporation.[1] If the IRS can require this level of reporting from S corporation shareholders, rather than shifting shareholder basis reporting to the S corporation itself, there is no reason the IRS cannot require similar information reporting from the partners in a partnership. The S corporation shareholder basis reporting rules make clear there is no reason or need to require partnerships to effectively compute and report partner-level basis amounts. Partners are also required to individually determine their at-risk basis and passive activity limitation amounts, which makes partner-level reporting of tax basis all that more appropriate.

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[1] *See* 2019 Instructions for Schedule E, p. E-11.

These additional proposed reporting requirements for partnerships do not appear properly tailored to address the above reporting issues, if in fact any such issues truly exist. Partners who do not properly report taxable transactions under the current reporting requirements may in fact be more likely to continue misreporting under the proposed reporting methodologies partly because they may be further confused by the numerous basis amounts provided on Schedule K-1. These new reporting requirements also do not appear sufficient to apprise the IRS of any such misrepresentations due to the partner-level determinations that have to be considered, such as at-risk calculations. For example, under the modified outside basis approach, if a partner previously misreported basis information to the IRS, the partner is likely to misreport that same information to the partnership as well.

There may also be a question as to whether the IRS has statutory authority to implement these new rules. We find it noteworthy that Congress recently amended the Internal Revenue Code to permit entity level audits and adjustments for partnerships.[2] There was no authority for the IRS to do so otherwise. For this same reason, we question whether the IRS has authority to effectively require partnership level reporting of partner basis amounts through the tax capital reporting requirements without express Congressional authority to do so.

Regarding the proposed alternative methods, we offer the following comments.

Modified Outside Basis Method

We have several concerns with the modified outside basis approach. First, these reporting requirements will necessitate a degree of sophistication from investors that could limit the flow of capital into partnerships. The specific issues that would need to be communicated from the partners to the partnership seem to include:

- Transfers/sales of partnership interests
- Inheritance of partnership interests
- Gifts made or received of partnership interests
- Loans associated with the partnership interests
- Suspended passive losses
- Suspended depletion
- Suspended Section 179 deductions
- At-risk limitations

All of these reflect technical aspects of federal partnership tax law, which require a fairly high level of sophistication to understand. As a result, this approach may discourage investment in partnerships by less sophisticated investors. The IRS would likely need to provide very detailed and specific guidance to partners by issuing a new form with instructions for a partner to report all necessary outside basis adjustments to the partnership. The frequent flow of information from the partner to the partnership feels like traveling upstream because it breaks with the long-standing tradition that it is the partner's responsibility to calculate basis and retain all supporting records.

Second, these requirements will likely necessitate amending most partnership agreements to require this information be provided by the partners on a regular basis and possibly provide some type of enforcement mechanism.

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[2] *Bipartisan Budget Act of 2015* effective for partnerships with tax years beginning after Dec. 31, 2017.

Third, this method will also require the partnership to keep either a separate set of books or a much more complicated set of books than under the transactional method. Considering that a partnership may already have multiple sets of books due to the application of Section 704(c), it is unreasonable to consider requiring yet another set of books for purposes of tracking partner outside capital accounts.

Finally, this approach would require disclosing information to a partnership that some partners may consider confidential (e.g., the purchase price of a partnership interest or at-risk calculations).

This method and these concerns reinforce the concept that the partners (rather than partnerships) should be required to maintain and report their tax bases. If a partner is in fact required to keep track of the above items in order to be in a position to report it to the partnership, then it is more practical that the partner should be required to compute and report its tax basis directly to the IRS, rather than shifting that burden to the partnership.

Modified Previously Taxed Capital Method

The modified previously taxed capital approach presents its own set of unique issues, partly because it could lend itself to manipulation. The allocation of partnership net assets frequently changes during the life of a partnership. Taking a 'snapshot' at any point in time could overlook previous allocations of income and losses and cause some partners to overstate or understate their basis.

This method will require a change in most partnership agreements and a new set of accounting records. There are also potential issues regarding the estimate of the fair market value of the partnership assets.

2. Whether an ordering rule should apply to the basis used in determining the partnership's net liquidity value; for example, use of fair market value is required, but if not readily available, Section 704(b) book basis is required, and, if the partnership does not maintain Section 704(b) capital, GAAP is required, etc.?

Although some ordering rules may be appropriate, the suggested methods seem impractical, burdensome and vague. For example, Notice 2020-43 does not specify what type of appraisal may be appropriate or required in determining fair market value (FMV). While partnerships could conceivably commission a formal appraisal of their assets each year, doing so would be cost-prohibitive and simply impractical for most partnerships. That being the case, under what circumstances could a partnership look to other sources to determine FMV? Could a partnership determine FMV based on ad valorem tax appraisals? These issues are not addressed in the notice and may require the IRS to issue further guidance.

We generally suggest, however, that if no other methods are reasonably available, tax basis should be an alternative after GAAP. This specifically helps small businesses that have no requirement to use GAAP and may not have access to resources necessary to restate financial statements regularly maintained on a cash basis or income tax basis.

3. How, if at all, the tax capital reporting requirement should be modified to apply to partnerships that are treated as publicly traded partnerships under Section 7704 of the Code?

We offer no comments on this question other than to note that, with a large number of unrelated partners frequently entering and exiting, publicly traded partnerships would likely have a great deal of difficulty tracking the information required.

4. Whether the transactional approach, or similar method, should be permitted for purposes of meeting the tax capital reporting requirement and, if recommended, what additional guidance would be necessary?

We believe the transactional approach should continue to be permitted with partners using the transactional information in the annual Schedule K-1 to adjust their individual basis computations. As explained in our letter dated July 29, 2019, some partnerships would be unable to calculate partner tax capital accounts using the tax basis method. However, a large percentage of partnerships successfully calculate basis using the transactional approach. The proposed modified outside basis method and modified previously taxed capital method might be appropriate as alternatives in the limited situations where the transactional approach is infeasible.

For partnerships that cannot ascertain their partners' tax bases, we suggest at a minimum permitting a partnership to use one of the methods in Notice 2020-43 to determine the initial tax capital account for its partners and then use that amount as a starting point for determining the tax capital accounts going forward. This would provide a partnership the initial basis for calculating its partners' tax capital accounts. Thereafter, the partnership could then use the transactional approach to update a partner's capital account or some other method based on information readily available to the partnership. In theory, there should be no need to make an annual liquidation calculation because the same amount could be reached with this more straightforward method while avoiding potential for more frequent errors.

However, our primary view continues to be that individual partners should ultimately be responsible for tracking their basis using transactions reported on Schedules K-1. This is not a responsibility that should be placed on partnerships, as Notice 2020-43 seeks to do.

5. Whether and in what circumstances limitations should be imposed on partnerships to change from one method to another (for example, whether there should be a limit on how many times the method can be changed over a period of years), including compliance with such rules in the case of the merger of partnerships using different methods?

We believe that partnerships should be permitted to change from one method to another periodically and in certain instances, for example, every five years as in the check-the-box rules, where the type of entity changes or in the event of a liquidation or merger. Otherwise, to avoid potential manipulation, it may be appropriate to preclude partnerships from changing their methods unless approved by the IRS. This is similar to how changes in accounting methods are generally handled.

Additional Comments

We offer the following comments that were not requested in the notice, but that we believe would be helpful to your consideration.

1. Exceptions to Application of the Requirement

If the proposed changes in Notice 2020-43 are adopted, we suggest providing exceptions to reporting tax basis capital to reduce the compliance burden effect on smaller to medium-size businesses, such as:

a) Exclude partnerships that do not meet minimum size requirements, such as partnerships with assets of less than $10 million or less than $2.5 million in annual gross receipts.
b) Exclude partnerships that have fewer than 100 or more than 1,000 partners.
c) Exclude partnerships that would not be required to file a balance sheet with its return.
d) Grandfather out partnerships formed more than five years before the new requirement.
e) Exclude partnerships that are eligible to opt out of the partnership audit regime.
f) For partnerships that have existed for more than five years, permit them to rely on the modified previously taxed capital method on a one-time basis and then carry forward the results using the traditional method.
g) It should be made clear that the partnership will not be held liable for incorrect information received from or for information that is not supplied by its partners.

2. Defer Effective Date

Due to the worldwide COVID-19 pandemic, compliance with these new reporting requirements will add to the costs and burdens of businesses when they are trying to recover from the economic fallout of the crisis. Many staff have been furloughed and compliance with these provisions will likely require a high degree of personnel interaction, which would be challenging during a lockdown crisis. Many predictions for a "second wave" exist and could occur just as this rule would take effect. We therefore suggest deferring the effective date of these new requirements.

3. Unfair Penalties

We recommend that no penalties be imposed for a significant transitional period of several years to permit partnerships to come fully into compliance if these new reporting rules are adopted. Otherwise, with a complex new set of rules and the practical difficulties of coming into compliance comes a particularly harsh penalty for failing to do so. Under Section 6698, a partnership is assessed a penalty of $195 per non-complying partner per month for up to a year, as adjusted for inflation. (For returns required to be filed in 2020, the penalty proposed is set at $205 per partner[3].) These penalties are automatically assessed. Thus, a partnership with only 10 partners could be penalized up to $24,600 after one year. A partnership with 100 partners could be penalized almost $250,000 after one year. Additional penalties could also apply under Section 6722 (failure to furnish correct payee statements) and Section 6038 (failure to furnish information with respect to foreign partnerships).

4. Foreign Partnerships

Special provisions may need to be added to address foreign partnerships. Many foreign partners and partnerships are treated like U.S. partnerships for U.S. tax purposes, but in some countries the form of business may be different from U.S. partnerships, with possible difficulties on compelling compliance with basis reporting.

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[3] https://www.irs.gov/instructions/i1065

5. Costs of Compliance

The cost of compliance will be excessive for many small and medium-size businesses, including professional fees for tax compliance with new and complex requirements. Return preparers will need time to train staff and tax return preparation software must be reprogrammed to comply.

Conclusion

We believe the alternative approaches provided in IRS Notice 2020-43 should be reconsidered for several reasons. First, these alternative approaches seek to improperly shift partner-level basis computations and reporting requirements to the partnership level. The maintenance of the partners' tax bases is more properly the responsibility of the partners, not the partnership. Second, to the extent these new reporting requirements are adopted, the transactional method works for many partnerships and should continue to be allowed. Third, if the transactional method is not workable, there should be a one-time calculation using the modified previously taxed capital method with the transactional method used to carry that result forward.

Furthermore, we recommend that exemptions be provided from these reporting requirements, the effective date postponed in light of the current coronavirus pandemic, special consideration given to foreign partnerships and penalties waived as partnerships make the transition.

Thank you for considering our comments. We would be pleased to discuss them further if you or your staff members believe it would be helpful. Please feel free to contact me at 832-333-7431 or at ddonnelly@cricpa.com or TXCPA Staff Liaison Patty Wyatt at 817-656-5100 or pwyatt@tscpa.net.

Sincerely,

David P. Donnelly, CPA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Principal responsibility for drafting these comments was exercised by David P. Donnelly, CPA; Kenneth M. Horwitz, JD, CPA; David E. Colmenero, JD, LL.M., CPA; and Julie Dale, CPA.

cc: The Honorable David Kautter, Assistant Treasury Secretary for Tax Policy
The Honorable Michael J. Desmond, Chief Counsel
Holly Porter, Office of Associate Chief Counsel (Passthroughs & Special Industries)
Clifford Warren, Special Counsel, Office of Associate Chief Counsel (Passthroughs and Special Industries)
Kara Altman, Office of Associate Chief Counsel (Passthroughs & Special Industries)

Attachment: TXCPA July 29, 2019 letter

July 29, 2019

The Honorable Charles P. Rettig
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue
Washington, D.C. 20224

RE: New Tax Basis Reporting Requirement in Instructions to Form 1065

Dear Commissioner Rettig:

The Texas Society of Certified Public Accountants (TXCPA) is a nonprofit, voluntary professional organization representing more than 28,000 members. One of the expressed goals of the TXCPA is to speak on behalf of its members when such action is in the best interest of its constituency and serves the cause of the CPAs of Texas, as well as the public interest. TXCPA has established a Federal Tax Policy Committee to represent those interests on tax-related matters. The committee has been authorized by the TXCPA Board of Directors to submit comments on such matters of interest to the committee membership. The views expressed herein have not been approved by the Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policies of the TXCPA.

We write to express our concerns regarding a recent change in the 2018 *Instructions to IRS Form 1065* requiring a partnership, under certain circumstances, to report its individual partners' tax basis in a partnership. Compliance will be difficult and expensive, if not impossible, for many existing partnerships and the prescribed penalty is excessive. Our concern primarily involves existing partnerships that have historically reported basis to partners in reliance on, and in accordance with, the IRS' prior rules. We request some reasonable exceptions, a delayed effective date, and a notice and comment period for this new requirement.

The 2018 Instructions to IRS Form 1065 Change the Requirements for Reporting Basis to a Partner

The recently revised 2018 Instructions for IRS Form 1065 require that "tax basis" capital must be reported for any partner whose tax basis capital account would be negative either at the beginning or end of the taxable year, regardless of the accounting method used to report the entity's balance sheet.[1] The instructions add that, "[f]or these purposes, the term 'tax basis capital' means (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."[2]

[1] 2018 Instructions for Form 1065 at p. 30.

[2] *Id.*

Prior to this new requirement, partnerships were generally required to report partner capital using tax basis, generally accepted accounting principles, Section 704(b) book, or some other method.[3] There was no requirement to report a partner's capital account using strictly a tax basis.

Failure to Comply May Result in Significant Penalties

Failure to comply with this new partner basis reporting requirement may result in significant penalties. Under Section 6698, a partnership is to be assessed a penalty of $195 per non-complying partner per month for up to a year, as adjusted for inflation. (For 2019, the penalty is $200 per partner.)[4] These penalties are automatically assessed.[5] Thus, a partnership with only 10 partners could be penalized up to $24,000 after only one year. A partnership with 100 partners could be penalized almost $250,000 after one year. Additional penalties could also apply under Section 6722 (failure to furnish correct payee statements) and Section 6038 (failure to furnish information with respect to foreign partnerships).

Although IRS Notice 2019-20 provides penalty relief where the partnership files the requisite basis information within one year of the original due date for taxable years that began after Dec. 31, 2017, but before Jan. 2, 2019, the notice does not extend the effective date, nor does it provide relief from the excessive penalties for any other circumstances.[6] In any event, this one-year extension of time for penalties applies only to the 2018 reporting year and may not provide enough time for many partnerships to come fully into compliance.

The New Requirement is Onerous and Even Impossible for Many Existing Partnerships to Satisfy

This new basis reporting requirement presents difficult compliance problems, particularly because it requires a beginning tax basis calculation for each partner. Arriving at a partner's beginning tax basis amount will require an analysis of all contributions and distributions, changes in ownership, changes in profit and loss allocations, special allocations, guaranteed payments and all other issues that might affect the partnership capital accounts since inception of the partnership. A partnership that has been in existence for 30 years would arguably have to go back 30 years to arrive at an accurate beginning tax basis amount.

In many cases, existing partnerships will be unable to access the historical documentation that would allow them to properly calculate each partner's beginning tax basis. These historical records may not even exist, especially given that they were not necessary under any previous requirement, and prior management, partners, records and professionals may no longer be available. Moreover, existing law only requires the taxpayer to keep records for as long as they may become material in the administration of any internal revenue law, which many taxpayers interpret to be until the statute of limitations for the requisite return expires.[7]

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[3] 2017 Instructions for Form 1065 at p. 28.

[4] IRC Section 6698(b); IRS Rev. Proc. 2017-57.

[5] Program Technical Advice 2013-015.

[6] IRS Notice 2019-20.

[7] Treas. Reg. Section 1.6001-1(e).

While this reporting requirement will be especially onerous for many smaller partnerships with limited resources, it will also be problematic for existing partnerships with a large number of partners, as it will require a historical tax basis calculation for each partner. Larger partnerships, particularly those with hundreds, or even thousands, of partners may be overwhelmed with computing this information on a historical basis. This would be especially concerning where individual partners have varying interests in the partnership and where partner turnover is high.

We understand the IRS may be concerned about individual partners who do not properly report the tax effect of distributions in excess of tax basis or losses in excess of their tax basis. While we recognize these issues may exist, the burden of proper reporting in these instances, including maintaining a taxpayer's outside basis amount, has historically been on the partner, not the partnership.

This Change Should Not Be Implemented Without a Proper Notice and Comment Period

Shifting this burden without appropriate regulatory notice and comment or express legislative authority seems inappropriate, particularly in view of the longstanding and extensive regulations under Section 704. This "tax basis" capital reporting requirement is analogous to a regulatory requirement, as it only appears in the 2018 Instructions to IRS Form 1065. While neither the code nor the regulations expressly impose this tax basis reporting requirement on partnerships, they incorporate form reporting requirements by reference.[8] As such, without a reasonable notice and comment period before imposing the requirement, the burden should remain on the reporting partner, not the partnership.

Recommendations

For the above reasons, we respectfully request that, at a minimum, the following revisions to this new requirement be implemented:

- Provide an exception from the new tax basis capital reporting requirement for partnerships with assets having a collective tax basis of less than $5 million.

- Provide an exception for partnerships that are below a certain number of partners, say 100, and above a certain number, say 1,000, with smaller partnerships having a disproportionate cost and larger partnerships having an onerous burden to comply.

- Given that this requirement is particularly burdensome for smaller partnerships which have been in existence for many years, grandfather the provision so that it applies to partnerships started since the new requirement.

- Alternatively, for partnerships that have existed for more than five years, permit those partnerships to rely on tax basis amounts provided by each of their partners for the beginning of a five-year look-back period and compute basis from that date forward in arriving at the current year tax basis amounts, rather than having to compute each partner's tax basis from the year of

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[8] IRC Section 6031(a); Treas. Reg. Section 1.6031(b)-1T(a)(3)(ii) (generally requiring partnerships to report information to the extent provided by forms or instructions).

inception. For example, a partnership could be permitted to simply ask a partner what their tax basis in the partnership was at the beginning of a five-year look-back period (e.g., Dec. 31, 2015, for the 2020 tax year) and compute tax basis from that date forward in order to determine the partner's beginning tax basis amount for the current year. Penalty waiver should also be available to partnerships that request information from a partner to comply with this new tax basis reporting requirement, but do not receive a timely response.

- Provide a reasonable opportunity for notice and comment before implementing this new reporting requirement and make it effective no earlier than for partnership tax returns due for the 2020 tax year or until the suggested process is complete. Partnership return preparation software is not ready to comply with the new requirement.

Thank you for considering our comments. We would be pleased to discuss them further if you or your staff members believe it would be helpful. Please feel free to contact me at 832-333-7431 or ddonnelly@cricpa.com or TXCPA Staff Liaison Patty Wyatt at 817-656-5100 or pwyatt@tscpa.net.

Sincerely,

David P. Donnelly, CPA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Principal responsibility for drafting these comments was exercised by David P. Donnelly, CPA; David E. Colmenero, JD, LL.M., CPA; Christina A. Mondrik, JD, CPA; Michael D. Williams, CPA; Kenneth M. Horwitz, JD, LL.M, CPA; Charles D. Pulman, JD, CPA and Paul Budd, JD, LL.M.

cc: David Kautter, Assistant Treasury Secretary for Tax Policy
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