Updated Partnership Reporting Requirements for 2019

December 13, 2019

In Notice 2019-66, released this week, the IRS clarified and provided some relief from reporting requirements otherwise applicable to partnerships filing Forms 1065 for tax years beginning in 2019. Specifically, the requirements to report capital accounts on the tax basis method and to report to partners' information about separate "Section 465 at-risk activities" have been deferred to tax returns with respect to years beginning in 2020. However, non-publicly traded partnerships must still report their partners' shares of "net unrecognized Section 704(c) gain or loss"—which the Notice defines as including reverse 704(c) gain arising from revaluations of partnership assets. This last requirement, which is new for 2019, could present substantial compliance challenges for partnerships that have not tracked this information.

I. Section 704(c) in the Spotlight

Section 704(c) is intended to ensure that, when a partner contributes built-in-gain or built-in-loss property to the partnership, the contributing partner will bear (and cannot shift to the other partners) the tax consequences of the built-in gain or loss. To that end, the regulations under Section 704(c) require that items of income, gain, loss or deduction with respect to the contributed property (such as depreciation deductions or gain recognized upon the property's disposition) be allocated disproportionately to the contributing partner under one of three methods until the entire book-tax difference at the time of contribution has been taken into income by the contributing partner. These allocations are known as "forward" section 704(c) allocations.

In certain circumstances, such as the admission of a new partner, a partnership is required to "book up" (or "book down") the value of its assets, and adjust existing partners' capital accounts to reflect the new asset values. The resulting difference between the partners' book capital accounts and their tax bases creates the same economic distortion as the contribution of property with built-in gain or loss, so section 704(c) allocations, known as "reverse" section 704(c) allocations, are required. As partners enter and leave a partnership over the years, layers of reverse section 704(c) allocations may develop. When draft 2019 forms and instructions released earlier this year proposed to require partnerships to report partners' shares of "net unrecognized Section 704(c) gain or loss," it was widely assumed that this requirement applied only to forward section 704(c) gain and loss. Notice 2019-66 clarifies that the reporting requirement also relates to reverse 704(c) allocations. The additional IRS scrutiny of section 704(c) likely to result from partnership reporting will put a premium on the importance of complete and accurate record-keeping and computations in respect of forward and reverse section 704(c) allocations.

II. Other Reporting Requirements Deferred

Outside the section 704(c) context, the Notice provides some welcome, albeit temporary, relief from other partnership reporting requirements that would otherwise have applied for tax years beginning in 2019. In particular, it defers to 2020 the requirement to report partner capital accounts on the tax basis method. To the extent that any partner's tax basis capital account was negative at the beginning or end of the partnership's 2019 tax year, however, such partner's beginning and ending tax basis capital must be reported in 2019 (as was true for 2018).

Thus, under the Notice, partnerships that have historically maintained section 704(b) or GAAP capital accounts have an additional year to make the transition to tax basis capital reporting—but the transition must still occur. Most partnerships have not previously reported partner capital accounts on the tax basis; many have not maintained tax basis capital account information and will have to reconstruct the numbers. We suspect that compliance with the new reporting requirements will be a formidable task for most partnerships and recommend that they use the additional year granted by the IRS to bring their records into compliance rather than wait until the 2020 tax return preparation season to do so.

The Notice also defers to 2020 a new requirement in the draft instructions for the 2019 Form 1065, Schedule K-1, concerning at-risk activity reporting. Specifically, partnerships having items of income, loss, or deduction reported on Schedule K-1 from more than one activity that may be subject to limitation under section 465 must (for 2020, but not for 2019) report related information separately for each activity on an attachment to a partner's Schedule K-1. Other reporting requirements pertinent to the at-risk activity rules still apply, and partnerships must begin tracking income items, partnership liabilities, and other relevant information on an activity-by-activity basis as of the first day of their 2020 tax years.

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Partnerships subject to the "net unrecognized Section 704(c) gain or loss" reporting requirement face a significant new compliance burden for 2019. The section 704(c) analysis is complex—particularly when layers of forward and reverse section 704(c) allocations have accumulated during past years. Attorneys in Caplin & Drysdale's Business, Investment, and Transactional Tax Group have extensive experience with the application of section 704(c) and both forward and reverse section 704(c) allocations. We are here to help clients and their accountants with respect to section 704(c) reporting compliance for 2019 and with compliance planning for the new reporting requirements that will take effect for 2020.

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