Reporting Partnership Tax Basis—The Rules
“They Are A-Changin’”

Tax year 2020 will see a change in the reporting of partners’ basis in partnerships. The Internal Revenue Service (IRS) recently issued Notice 2019-66, which provided a rule update. Previously, a partnership was permitted to use any reasonable method to report partners’ basis, but the new rules require that partnerships use the tax basis for reporting.

In order to convey the full impact of this change, we have provided some definitions and context in the PYA Insight that follows.

**Partnership and Basis Defined**

A partnership is an entity that elects to be recognized as such by the IRS. The defining quality of a partnership is that it has two or more taxpayers that agree to come together for a business purpose. The taxpayer may be an individual, or it may be another business entity or even a trust. The partners should execute a partnership agreement and each year must file a Form 1065: U.S. Return of Partnership Income with the IRS.

When the partnership is formed, each partner should contribute cash or noncash property to the partnership, thus creating *basis* in the partnership. Going forward, income and further cash or noncash contributions increase a partner’s basis, and losses and distributions of cash or noncash property to a partner decreases a partner’s basis. To complicate matters, sometimes the income or loss is different when calculated using financial accounting (book) rules than when using tax accounting rules. This can cause a book-tax difference in a partner’s basis.

**Book-Tax Difference**

The most common form of book basis is generally accepted accounting principles (GAAP). GAAP rules differ from tax rules in many areas—depreciation expense, installment sale income, and federal income tax expense, to name but a few. When the income and expenses are different on the book basis than on the tax basis, each partner’s basis will also be different when calculated using the book basis versus the tax basis. The obvious question is: Why does it matter that there are two different calculations of basis?

Some partnerships are required by their auditors, lenders, and other regulatory bodies to maintain books and records on the GAAP basis. Thus, their financial statements are reported in accordance with GAAP. However, the IRS will not allow a partnership to file a tax return using the GAAP basis of
accounting. The IRS requires the financial statement to be converted to tax basis when filing Form 1065. Interestingly, however, prior to the new rules, the partnership basis reported on Part L of Schedule K-1: Partner’s Share of Income, Deductions, Credits, etc. filed with the partnership’s Form 1065 was on the financial accounting or book basis.

Why is maintaining partners’ tax basis so important? There are two main reasons. The first is that a partner’s ability to take partnership losses on his individual income tax return may be limited if the ending tax basis is negative. Similarly, if a partner receives from the partnership a cash or noncash property distribution that is in excess of his tax basis, then the excess may be taxable income to the partner. The second is that the gain or loss a partner recognizes on the sale of his partnership interest is calculated using his tax basis. If a partner receives cash or other consideration that is in excess of his tax basis, then he should recognize a gain on the sale of his partnership interest on his individual income tax return.

The New Basis-Reporting Rule

Originally, the new rules applied to tax year 2019 (taxable years that began on or after January 1, 2019). In these rules, partnerships were required to report partners’ basis on Part L of Schedule K-1 on tax basis. Partnerships were no longer allowed to report basis using another method of accounting, such as GAAP. However, the IRS recognized that many taxpayers would struggle to timely transition their methodology of calculating partner basis to the new requirement to meet the due dates for 2019 returns. Therefore, Notice 2019-66 provides relief and postpones the requirement until tax year 2020 (taxable years that began on or after January 1, 2020).

As we commence the filing season for 2019 returns, partnerships and tax preparers are permitted to rely upon the 2018 Form 1065 instructions and rules when preparing partnership returns. The IRS promises guidance on the new rules during 2020, so partnerships and tax preparers will be ready to implement them during the filing season for 2020 tax returns. However, it is important to begin the process of transitioning to accounting for partners’ tax basis as early as possible.

Some partnerships may have been in existence for many years and may have had a taxpayer as a partner for decades. Prior to the new rules, a partner—not the partnership—was responsible for maintaining a calculation of his tax basis in the partnership. If the partnership or tax preparer had not previously kept a calculation of each partner’s tax basis, then catching up the calculation to 2020 could be a cumbersome process.

There are still unanswered questions about the new partnership basis reporting rules. Though the IRS anticipates guidance will be released in the coming year, practitioners should begin planning now.

If you have questions about partnership basis or reporting and record-keeping of partner tax basis, or would like assistance with any matter involving tax preparation and strategy or audit and assurance, contact a PYA executive below at (800) 270-9629.

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