AUGUST 2020
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# ASSET MANAGEMENT INSIGHTS

INSIGHTS FROM THE BDO FINANCIAL SERVICES PRACTICE

## TWO PROPOSED METHODS FOR REPORTING TAX CAPITAL ON SCHEDULE K-1

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On June 5, 2020, the IRS released Notice 2020-43, requesting public comments on a proposed requirement for partnerships. Under the proposed requirement, partnerships would use one of two methods to satisfy the tax capital reporting requirement for tax years that end on or after December 31, 2020: the Modified Outside Basis Method or the Modified Previously Taxed Capital Method.

Previously, instructions published by the IRS for both tax years 2018 and 2019 required partnerships, including hedge funds, private equity funds, and other investment partnerships that reported partners' capital on a method other than the tax basis method, to report a partner's tax capital account at the beginning and end of the year if either amount was negative.

Following the publication of these instructions, commenters provided feedback to the Treasury Department and the IRS regarding the ability of partnerships to provide tax basis capital details. In particular, commentators stated that some partnerships might be unable to comply, either in a timely manner or ever, with tax basis capital reporting required under a transactional analysis. Difficulties in applying this transactional analysis approach may arise due to lack of available information or volume and complexity of existing information.

In response to these comments and the inherent difficulty in defining tax basis capital, the Treasury Department and the IRS have proposed the Modified Outside Basis and the Modified Previously Taxed Capital Methods to satisfy this reporting requirement. Under the notice, if adopted, for tax years ending on or after December 31, 2020, a partnership would be able to meet the tax capital reporting requirement only under one of the two methods. Further, a switch from one method to the other would only be permissible with a disclosure attached to each Schedule K-1.

Read on for a discussion of the proposed methods under Notice 2020-43.

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BDO's Asset Management practice provides assurance, tax and advisory services to asset management entities, comprising hedge, private equity and venture capital funds as well as regulated funds. The practice services over 600 advisors nationwide with funds ranging from start-up funds to those with billions under management.

## THE MODIFIED OUTSIDE BASIS METHOD

A partnership may satisfy the Tax Capital Reporting Requirement by determining, or being provided by each of its partners, the partner's adjusted basis in its partnership interest, determined under the principles and provisions of subchapter K, and subtracting from that basis the partner's share of partnership liabilities.

A partner must provide written notice within 30 days or by year-end, whichever is later, of any changes to the partner's basis in its partnership interest other than changes attributable to contributions, distributions, and share of income, gain, loss or deduction reflected on Schedule K-1.

## MODIFIED PREVIOUSLY TAXED CAPITAL METHOD

A partnership that does not satisfy its tax capital reporting requirement by using the Modified Outside Basis Method would be required to do so by using the Modified Previously Taxed Capital Method. Existing Treasury regulations generally provide that a partnership interest transferee's share of the adjusted basis of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. As provided by Treasury Regulation Section 1.743-1(d)(1), a transferee's interest as a partner in the partnership's previously taxed capital is equal to:

- The amount of cash (partnership net liquidity value) that the partner would receive on a liquidation of the partnership following a disposition of all the assets in a fully taxable transaction, increased by
- The amount of tax loss allocable to the partner from disposition of all the assets, and decreased by
- The amount of tax gain allocable to the partner from disposition of all the assets.

For purposes of the Tax Capital Reporting Requirement, the Modified Previously Taxed Capital Method modifies the methodology above in two ways:

- The cash a partner would receive on a partnership liquidation and calculations of gain and loss in the hypothetical transaction would be based on the assets' fair market value, if readily available. Otherwise, a partnership may determine its partnership net liquidity value and gain or loss by using such assets' bases as determined under Section 704(b), GAAP, or the basis set forth in the partnership agreement, for purposes of determining what each partner would receive if the partnership were to liquidate, as determined by partnership management; and
- All liabilities are treated as nonrecourse for purposes of parts (2) and (3) of the calculation referring to gain or loss, respectively. This is to avoid the burden of having to characterize the underlying debt and to simplify the computation.

A partnership choosing the Modified Previously Taxed Capital Method would be required for each applicable tax year to attach a statement indicating that the Modified Previously Taxed Capital Method is used and the method it used to determine its partnership net liquidity value (for example, fair market value, Section 704(b) book basis, etc.).

Written or electronic comments on Notice 2020-43 are due on August 4th, 2020.

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