Capital Accounts: 704(b) vs. GAAP vs. Tax Basis, Comparing and Contrasting Annual Allocations

TUESDAY, JUNE 1, 2021, 1:00-2:50 pm Eastern

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Agenda

- Partnership Capital Accounts – Overview
- GAAP Capital Accounts
- §704(b) Capital Accounts
- Tax Basis Capital Accounts
- Reporting Issues

Overview of Capital Accounts

What are Capital Accounts

- Represents the partners’ equity in the partnership
- GAAP capital accounts – maintained in accordance with generally accepted accounting principles
- Book basis capital accounts – represents the partners’ economic interest in the partnership and relationship with each other
- Tax basis capital accounts – a component of tax basis in the partnership interest

Basis vs. Capital Account

Inside tax basis of assets

Book basis of assets

	Tax Basis	Book Basis
Cash	$ 100,000	$ 100,000
Land	10,000	100,000
Building	900,000	900,000
Total Assets	$ 1,010,000	$ 1,100,000
Mortgage	$ 900,000	$ 900,000
Capital		
Partner A	$ 10,000	$ 100,000
Partner B	$ 100,000	$ 100,000
Partners' Capital	$ 110,000	$ 200,000
Total Liabilities and Capital	$ 1,010,000	$ 1,100,000

Book capital accounts

Outside basis (basis in partnership

GAAP vs. Tax vs. §704(b) Capital Accounts

Start	→	GAAP Capital Account
	+ / -	GAAP to Tax Differences
	=	Tax Basis Capital Account
	+ / -	§704(c) Adjustments
	=	§704(b) Capital Account

- GAAP income is the typical starting point
- Determine taxable income by adjusting for M-1/M-3 items
- Determine §704(b) income (economic income) by adjusting for differences between tax basis and §704(b) basis
- §704(b) basis may not equal tax basis for property (i) contributed with a fair market value different than tax basis and (ii) § 704(b) revaluations (collectively "§704(c) property")
- Differences between §704(b) and tax basis are addressed through §704(c) allocations
- GAAP capital may not equal §704(b) capital

GAAP Capital Accounts

GAAP Basis Capital Accounts

- GAAP capital accounts are maintained based on GAAP rules, as defined by the Financial Accounting Standards Board ("FASB").

- GAAP only applies to partnerships that are publicly traded and registered investment partnerships. However, many partnerships are required by auditors, lenders, or other regulatory bodies to maintain records and accounts in accordance with GAAP. Thus, these partnerships also report their financial statements in accordance with GAAP.

GAAP Basis Capital Accounts

- The method used to account for an investment depends on the degree of influence the investor can exert over the investee's operating and financial policies. These methods are not elective, but management discretion exists in determining whether the investor's ownership interest meets "significant influence" (equity) or "control" (consolidation).
- **Consolidation** (ASC 810): Investor controls another entity through ownership of a majority (more than 50%) of its outstanding voting stock or through control as determined by ASC 810.
- **Equity Method** (ASC 323): Investor has ability to exercise significant influence over operating and financial policies, even though investor holds 50% or less of the voting stock (also applies to investments in joint ventures).
- **Mark-to-Market** (ASC 320): Investor lacks ability to significantly influence the investee's financial and operating policies. [This assumes investment in publicly traded securities or otherwise readily determinable fair value. Furthermore, this is subject to recent changes in accounting guidance.]

GAAP Basis Capital Accounts

- GAAP capital accounts may reflect FMV if a transaction takes place that requires purchase accounting adjustments, for example, where there's a change in majority owner of the business. This is similar to Sec. 704(b) capital accounts, but the rules for when such accounts are adjusted to reflect FMV are different for GAAP and Sec. 704(b) purposes.
- GAAP capital accounts have limited impact on tax basis and Sec. 704(b) capital accounts, but as a practical matter are often the starting point for these other accounts.
- *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.*

Other Methods for Maintaining Capital Accounts

- Other methods of maintaining capital accounts:
- Modified GAAP
  - In practice, some businesses apply GAAP principles but don't strictly adhere to GAAP ("OCBOA" – other comprehensive basis of accounting)
- International Financial Reporting Standards ("IFRS")
  - International standard developed by Int'l Accounting Standards Board ("IASB") used in more than 110 countries around the world, including EU and many Asian and South American countries.

704(b) Capital Accounts

704(b) Capital Accounts

Effect of Liabilities on Section 704(b) Capital

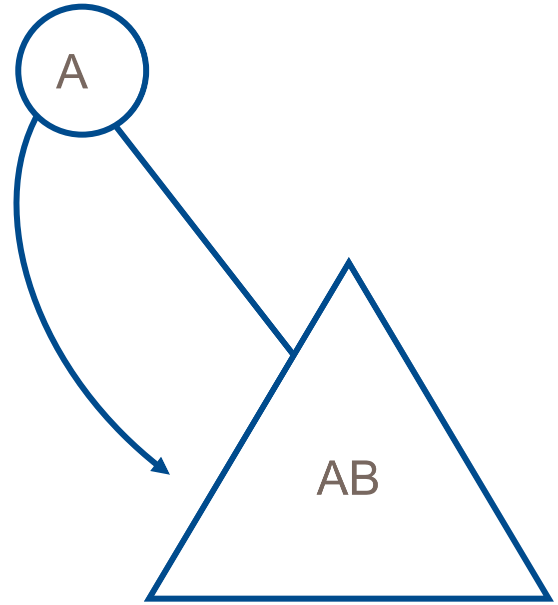
- *Assumption* of partner liability by partnership treated as cash distribution. Includes contribution of property subject to liability
- *Assumption* of partnership liability by partner treated as cash contribution. Includes distribution of property subject to liability
- Changes to allocable share of partnership liabilities is not an assumption and has no effect on capital

704(b) Capital Accounts
Effect of Liabilities on Section 704(b) Capital

Example:

	Value	Basis
Building	$100	$50
Mortgage	($ 60)	($60)

$120 of AB's liabilities are allocable to A after the contribution.

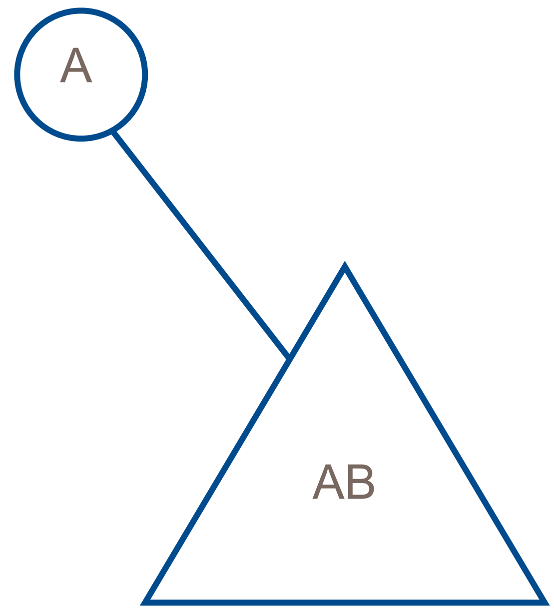


What is A's Capital Account?
What is A's Basis in AB?

704(b) Capital Accounts
Effect of Liabilities on Section 704(b) Capital

	Value	Basis
Building	$100	$50
Mortgage	($ 60)	($60)

$120 of AB's liabilities are allocable to A after the contribution.



Capital = $100 Building Value - $60 Mortgage assumed by AB = **$40**
Basis = $50 Building Basis - $60 Mortgage + $120 Liability Allocation = **$110**

704(b) Capital Accounts
Effect of Liabilities on Section 704(b) Capital

- No increase for contribution of a partners' own note until the note is sold or as principal payments are made.
- No decrease for distribution of the partnership's own note until the note is sold or as principal payments are made.
- If note is readily tradable on an established securities market the forgoing rules are inapplicable.

704(b) Capital
Safe-Harbor Allocations

Economic Effect

- An allocation must be consistent with the underlying economic arrangement of the partners.
- Partners that are allocated income or loss must ultimately bear the economic benefit or burden associated with the allocations
- Regulatory Safe-Harbors
  - General Test for Economic Effect
  - Alternate Test for Economic Effect
  - Economic Effect Equivalence
- Allocations that do not meet a regulatory safe-harbor are allocated based on the partner's interest in the partnership ("PIP")

704(b) Capital
General Rules for Annual Income Allocation

Section 704(a): Except as otherwise provided in the Code, a partner's share of partnership income items is determined by the partnership agreement.

Section 704(b): A partner's share of income items is determined in accordance with the partner's interest in the partnership ("PIP") if the allocations per the partnership agreement do not have ***Economic Effect***. Regulations provide that the allocations must also be ***Substantial***.

704(b) Capital
Safe-Harbor Allocations

General Test for Economic Effect

1. Partnership maintains Section 704(b) Capital Accounts;
2. Liquidating distributions made in accordance with positive Section 704(b) Capital Accounts; and
3. Partners have obligation to restore any negative capital account balance (a "Deficit Restoration Obligation" or "DRO")

Alternate Test for Economic Effect

1. Partnership maintains Section 704(b) Capital Accounts;
2. Liquidating distributions made in accordance with positive Section 704(b) Capital Accounts; and
3. In lieu of a DRO, the partnership agreement contains a Qualified Income Offset ("QIO") provision

Economic Effect Equivalence Partnership agreement does not satisfy the General or Alternate Test of economic effect. However, allocations are deemed to have economic effect if, as of the end of each partnership taxable year, a liquidation of the partnership at the end of such year or at the end of any future year would produce the same economic results to the partners as would occur if the General Test of economic effect had been satisfied.

704(b) Capital
Safe-Harbor Allocations

Substantiality

- The economic effect of an allocation is substantial if there is a reasonable possibility that the allocation will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences.
  - **Overall Tax Effect Rule**: One partner benefits at the expense of another
  - **Shifting Tax Consequences**: The net increases/decreases in the partners' respective capital accounts won't differ substantially from the baseline allocations and the aggregate tax liability of the partners will be reduced
  - **Transitory Allocations**: There is a possibility that original allocations will be largely offset by offsetting allocations, providing there is a strong likelihood that the net increases/decreases in the partners' capital accounts won't differ substantially from the baseline allocations and the total tax liability of the partners will be reduced in present value terms

704(b) Capital
Targeted or PIP Allocations

In General

- Liquidating distributions are not based solely on the partner's Section 704(b) Capital Accounts
- General and Alternate Test of Economic Effect cannot apply
- Targeted Allocations may have Economic Effect Equivalence or may be in accordance with PIP
- Profits & loss allocations (including gross income) are generally made in the amounts necessary to ensure ending Section 704(b) Capital Accounts reflect the partner's liquidating distribution rights

704(b) Capital
Targeted Allocations

Safe-Harbor Allocations	
	Capital Account
Beginning	$50
Income/(Loss)	$100
Ending Capital	**Calculated**

Targeted Allocations	
	Capital Account
Beginning	$50
Income/(Loss)	**Calculated**
Distribution Rights	$150

704(b) Capital
Revaluations

- Partnership may periodically revalue Section 704(b) capital accounts
- Regulations provide for ***Mandatory*** and ***Optional*** revaluations
- Revaluations must reflect fair market value of partnership property at the date of revaluation
- Allocation of book-up or book-down adjustment must reflect the way the unrealized gain or loss would be allocated if recognized
- Revaluations have no impact on tax basis of assets therefore create additional Section 704(c) layers
- Revaluations generally have no GAAP impact, but transactions that trigger purchase accounting rules may have a similar impact (i.e. partnership merger)

704(b) Capital Revaluations

Mandatory Revaluations

- Partnership is required to revalue distributed assets immediately ***before*** the partnership distributes property to any partner

- Partnership is required to revalue capital accounts immediately ***after*** an exercise of a noncompensatory option

Optional Revaluations

- Partnership may choose to revalue capital accounts upon certain events:
  - Contributions of money or property for a partnership interest
  - Liquidation or distribution as consideration for a partnership interest
  - Grant of a partnership interest as consideration for services rendered
  - Issuance by the partnership of a noncompensatory option, or
  - Generally accepted industry accounting practices (hedge funds)

Tax Capital Accounts

Tax Capital Accounts
Recent History

- Tax Capital is not defined in the Internal Revenue Code or Treasury Regulations
- TY2018 – Introduction of negative tax capital account reporting
- TY2019 - Mandate to report partner capital accounts on Schedule K-1, subsequently delayed one year
- TY2020 - Mandate to report partner capital accounts on Schedule K-1
  - For real this time!

Tax Capital Accounts
Permissible Methods

- Tax Basis Method (i.e. Transactional Approach)
- Modified Outside Basis Method
- Modified Previously Taxed Capital Method
- Section 704(b) Method

- How do we begin 2020 with this new guidance in hand?

Tax Capital Accounts
Tax Basis Method

- Mandatory if:
  - Partnership previously reported tax capital on Schedule K-1, or if
  - Partnership maintained tax capital accounts in books and records
- Account for events by using the rules and principles of Sections 705, 722, 733, and 742 as a guide.
- Prepare allocation of income by using the rules and principles of Section 704.
  - “Tax follows (704(b)) Book.”
- Section 734(b) adjustments

Tax Capital Accounts
Impact of Section 704(c)

- **Section 704(c):** Income items with respect to property contributed to the partnership by a partner shall be shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution.
  - GAAP, Tax, & 704(b) Capital reconcile variances between Tax Basis and Section 704(b) Basis
  - Built-in gain or loss on the sale of contributed property must be allocated back to the contributing partner
  - Tax depreciation/amortization on contributed property is allocated first to the non-contributing partner in an amount equal to the partner’s Section 704(b) depreciation

Tax Capital Accounts
Impact of Section 704(c)

Section 704(c) rules apply to:

- Contributions of property where the Section 704(b) value (FMV) is not equal to the tax basis ("Forward Section 704(c) Layers")
- Book up or down adjustments caused by Section 704(b) revaluations ("Reverse Section 704(c) Layers")
- Possible to have multiple Forward and Reverse Section 704(c) Layers

Tax Capital Accounts
Section 704(c) Tax Depreciation Allocation

- Traditional Method
  - Allocations are limited to the tax items associated with the contributed property.
  - Ceiling rule limitations are not fixed, and the built-in gain shifts to noncontributing partners.
- Traditional Method with Curative Allocations
  - Start with the traditional method
  - Reallocate other partnership items to overcome ceiling rule
  - Other items must generally have the same effect as depreciation.
- Remedial Method
  - Provide correct amount to non-contributing partners.
  - If figure that exceeds total tax items, contributing partner picks up offsetting income.

704(b) & Tax Capital Accounts

704(b) v. Tax

	Section 704(b) Capital	Tax Basis Capital
Increases:	• FMV of property contributions, including money	• Tax basis of property contributions, including money
	• Partner share of Section 704(b) income	• Partner share of taxable income
	• Positive Section 704(b) revaluations (book-ups)	• No change due to Section 704(b) revaluations (book-ups)
Decreases:	• FMV of property distributions, including money	• Tax basis of property distributions, including money
	• Partner share of Section 704(b) losses	• Partner share of tax losses
	• Negative Section 704(b) revaluations (book-downs)	• No change due to Section 704(b) revaluations (book-downs)

Capital Account Reporting Issues and Requirements

Tax Basis Capital Reporting Requirements

- Beginning with 2018 tax year, partnerships reporting partners' capital on a method other than the tax basis method were required to report partners' tax capital accounts at both the beginning and the end of partnership's taxable year if either amount was negative with respect to the partner.
- On March 7, 2019, **Notice 2019-20** was released providing penalty relief for partnerships that file and furnish Schedules K-1 but fail to report info about partners' negative tax capital accounts for 2018 partnership tax years.
- On February 12, 2021, IRS released Form 1065 and Instructions with early draft versions in October 2020, January 2021 and February 2021 requiring the reporting of partner capital accounts on Item L of Schedule K-1 on a tax basis.

Tax Basis Capital Reporting Requirements

- The instructions and Notice 2021-13 require partnerships to calculate and report partner capital accounts using the transactional approach for the tax basis method, irrespective of whether the beginning or ending balance is negative.
- If a partnership did not report its partners' capital accounts using the tax basis method in 2019 and did not maintain its partners' capital account under the tax basis method in its books and records, the partnership may determine its partners' beginning capital accounts for the 2020 taxable year using (i) tax basis method, (ii) modified outside basis method, (iii) modified previously taxed capital method, or (iv) section 704(b) method.

Complying With The Tax Basis Capital Requirement

- **Transactional Method (Tax Basis Method)** – inception to 2020 contributions, distributions and withdrawals, and distributive share of taxable income/separately stated items on the tax basis
- **Modified Outside Basis Method** – partner's outside basis in its partnership interest less the partner's share of partnership liabilities and §743(b) adjustments
- **Modified Previously Taxed Capital Method (Hypothetical Liquidation Method)** – the cash the partner would receive if the partnership liquidated immediately following the taxable sale of all of its assets for their fair market value plus the tax losses and less the tax gains that would be allocated to the partner in the hypothetical transaction (excluding §743(b) adjustments
- **Section 704(b) Method** – partner's 704(b) capital account less share of 704(c) gain and plus share of 704(c) loss.

Partnership Books and Records

- Proper **maintenance of books and records** requires maintenance of:
  - cumulative, period-by-period, recording of each partner's and the partnership's inside tax capital accounts;
  - cumulative period-by-period historical Sec. 704(b) income allocations and current period Sec. 704(b) income allocations;
  - cumulative summary of ownership detailing total interests issued by class and on a partner-by-partner basis; and
  - copies of Partnership Agreement(s) and all amendments, contribution agreements, side letters, etc.

Partnership Books and Records

- Other components of partnership books and records include:
  - **Outside Basis Schedule** – tracking outside basis adjustments and allocation differences, as well as partner-by-partner debt allocations on an annual basis;
  - **Liability Allocations** – particularly when Sec. 704(c) is implicated, the allocations under Sec. 752 become more challenging;
  - **Profits Interest Grants** – can impact allocations in any given period and going forward; should be tested for compliance under the revenue procedures; may implicate a revaluation of capital accounts.