COMMENTS ON VISION DRAFT 6/18/03 OF SCHEDULE K-1 (FORM 1065)

The following Comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Partnerships of the Section of Taxation. Principal responsibility was exercised by Michael J. Grace. Substantive contributions were made by Michael Hirschfeld, James Lynch, John O. Tannenbaum, and William P. Prescott. The Comments were reviewed by Robert E. Liles, II of the Section’s Committee on Government Submissions and by Jerald D. August, Council Director for the Committee on Partnerships.

Although many of the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

Contact Person:
Michael J. Grace
202-457-4278
mgrace@jacksamp.com
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I. EXECUTIVE SUMMARY

Revising Schedule K-1 (Form 1065) has its advantages and disadvantages. On balance, we believe that a revised Schedule K-1 modeled on the Vision Draft would work well once users adjust to it.

The IRS hopes to adopt a revised Schedule K-1 for partnership taxable years beginning in 2004. We endorse this goal provided that the IRS releases the final version of revised Schedule K-1 by October 2003. Alternatively, the IRS first could “test market” the revised form and adopt it in 2005.

We understand and appreciate the IRS’s reasons for not proposing both a revised Schedule K-1 and a Schedule K-1 EZ. However, we urge the IRS to reconsider Schedules K-1 EZ once adequate experience has been gained with the revised Schedule K-1.

A longstanding issue has been whether the IRS should require all partnerships to maintain and report partners’ capital accounts using the same method. A partnership currently may but is not required to use the rules in Regulation Section 1.704-1(b)(2)(iv) to determine partners’ capital accounts in Schedule K-1 and Form 1065, Schedule M-2. This complex issue requires additional analysis. Members of the Section of Taxation will try to comment on it separately. For the time being, we would endorse the IRS’s requiring a partnership to indicate with Schedules K-1 and M-2 the method used to maintain and report its partners’ capital accounts.

In the final section of this submission (Section V), we comment on specific lines and instructions of the Vision Draft.
II. BACKGROUND AND PERSPECTIVE

At a meeting in Washington, DC on June 18, 2003, the IRS unveiled a proposed revision of Schedule K-1 (Form 1065), “Partner’s Share of Income, Credits, Deductions, etc.” (the “Vision Draft”). Led by the IRS’s Office of Taxpayer Burden Reduction, the meeting was attended by individuals representing various other divisions of the IRS and by external stakeholders from various professional organizations. In redesigning Schedule K-1, the IRS identified three main “Project Objectives”: simplify Schedules K-1, reduce taxpayer burden, and improve the K-1 matching process.

The IRS invited public stakeholders, including the Section of Taxation, to comment on the Vision Draft. These comments respond to that invitation.

III. ADVANTAGES AND DISADVANTAGES OF REVISING SCHEDULE K-1 AS PROPOSED

The IRS identified five advantages of the Vision Draft compared to current Schedule K-1. We believe that revising Schedule K-1 as the Vision Draft proposes has the following major advantages and disadvantages.

Advantages

1. Shortens Schedule K-1 from two pages to one page (in part by moving all cross references from Schedule K-1 to its instructions).
2. Presumably facilitates IRS processing of Schedules K-1 and matching of items between Schedules K-1 and partners’ returns.
3. Provides more cross references to forms and schedules on which individual partners should report items.
4. Provides specific lines for reporting many items currently reported on Line 25 (“Supplemental Information”).
5. Offers a cleaner, less cluttered format.

Disadvantages

1. Moves from Schedule K-1 itself to its instructions all cross references to other forms.
2. Separates naturally grouped items (e.g., portfolio income (loss), currently reported on lines 4a-f of Schedule K-1).
3. Provides fewer line items on Schedule K-1 itself, moving many line items to the instructions.
4. Significantly changes a form with which tax preparers, partnerships, partners, and IRS Service Centers have familiarized themselves.
5. Potentially increases the number of attached schedules. Currently, many “Attach Schedule” items are explained on line 25, page 2 of Schedule K-1.3

Appraisal

On balance, we believe that a revised Schedule K-1 modeled on the Vision Draft would work well once users adjust to it. In transitioning to the new form, partnerships, partners, and return preparers inevitably will have questions about how to report particular items and events. We recommend that, when it releases the revised Schedule K-1, the IRS also issue a list of anticipated questions and the Service’s answers.

When it unveiled the Vision Draft, the IRS stated that it hopes to adopt the revised Schedule K-1 for partnership taxable years (including calendar years) beginning in 2004. We endorse this goal provided that the IRS releases the final version of the revised Schedule K-1 by October 2003. Alternatively, the IRS first could “test market” the revised form and adopt it for taxable years beginning in 2005.

The IRS also explained that it considered but rejected the idea of both revising Schedule K-1 and issuing a separate Schedule K-1 EZ.4 We understand and appreciate the IRS’s reasons for not proposing a Schedule K-1 EZ. However, we urge the IRS to reconsider the possibility of Schedules K-1 EZ once adequate experience has been gained with the revised Schedule K-1.5

IV. PARTNER CAPITAL ACCOUNTS

Discussed briefly at the meeting on the Vision Draft was whether the IRS should require all partnerships to maintain and report partners’ capital accounts using the same method. The IRS invited comments on that issue.

Background

Both the existing Schedule K-1 and the Vision Draft request an “analysis” of the partner’s capital account. The partnership is directed to report on Schedule K-1 the partner’s beginning capital account, any increases or decreases during the year, and ending capital account. Form 1065, Schedule M-2 requires an aggregate analysis of partners’ capital accounts.

The regulations under Code Section 704(b) prescribe rules for maintaining partner capital accounts. The capital accounts maintained under those rules may be used to determine whether a partnership has allocated items to or among partners in a manner having “economic effect.”6 In general, capital accounts must be maintained under the regulations on a “book” basis using the book value rather than the tax basis of property.7

The instructions accompanying Form 1065, Schedule M-2 state that a partnership may, but is not required to, use the rules in Regulations Section 1.704-1(b)(2)(iv) to determine the partners’ capital accounts in Schedule M-2 and Item J of Schedules K-1. If, however, the beginning and ending capital accounts reported under those rules differ from the amounts reported on Form 1065, Schedule L (Partnership Balance Sheet), then the partnership is directed to attach a statement reconciling any differences.8 The Partner’s Instructions for Schedule K-1
Note that the changes to capital account on Schedule K-1 are based on the partnership’s books and records and, thus, cannot be used to figure a partner’s basis in a partnership interest.9

**Various Methods**

Partnerships use various methods to report capital accounts on Schedules K-1 and Form 1065, Schedule M-2. Some partnerships strictly follow the rules in the regulations under Code Section 704(b). Other partnerships maintain their capital accounts on a “book” basis but not strictly under the regulations. Still other partnerships maintain capital accounts in accordance with generally accepted accounting principles. Some partnerships report their capital accounts on a “tax” basis, using the tax basis rather than the book value of property. Other methods may be used depending on the nature of the partnership’s business.

These variations present some challenges. It frequently proves difficult to identify the method a partnership has used to maintain capital accounts. Without knowing the method and whether that method was correctly applied, it can prove difficult to determine whether a partner’s stated capital account balance measures the partner’s ability to be allocated losses and deductions or to receive distributions of money or other property under Code Section 704(b).

**Issues**

This state of affairs raises two issues. First, should the IRS require all partnerships to maintain and report capital accounts using the same method? Second, if a consistent method is not required, then should the IRS require a partnership to indicate the method it uses?

The first issue raises numerous complexities. For example, how would existing partnerships transition to a single required method, and with what (if any) tax consequences to the partners? Valid business reasons may exist for using a different method depending on the nature of a partnership’s business. We recommend that before mandating a single method, the IRS evaluate those reasons. Members of the Section of Taxation will attempt to address this first issue in a separate, subsequent comment.

We would endorse the IRS’s requiring a partnership to indicate with Schedules K-1 and M-2 the method used to maintain and report capital accounts. Such an indication would help return preparers, partners, and the IRS better use the information reported on Form 1065 including Schedule K-1.

**V. COMMENTS ON SPECIFIC LINES AND INSTRUCTIONS OF VISION DRAFT**

In this final section, we comment on specific lines and instructions of the Vision Draft. The subheadings below to “parts” refer to the three parts (I, II, and III) of the Vision Draft.

We refer frequently here to the instructions accompanying the current forms. These instructions consist of the Partner’s Instructions for Schedule K-1 (Form 1065) (2002), and the specific instructions for Schedules K and K-1 included in the Instructions for Form 1065 (2002).
The proposed instructions in the Vision Draft refer to the “K-1 Instructions.” This language presumably references revised instructions that would accompany the revised Schedule K-1.

Check boxes indicating special situations. The Vision Draft helpfully moves to the top of Schedule K-1 the boxes to check indicating “Final K-1” or “Amended K-1.” Currently, those boxes are buried with other information. This change will more readily alert partners and the IRS to these special situations.

The Partner’s Instructions for Schedule K-1 suggest circumstances under which a partner should request from a partnership a “corrected” Schedule K-1. We assume that an “amended K-1” includes a “corrected K-1.” We recommend that the instructions clarify the point.

Part I

Line 1. The Vision Draft requests the partnership’s “Employer ID Number.” Current Schedule K-1 requests the partnership’s “Identifying Number.” The term “Employer ID Number” seems technically correct.

Line 2. The Vision Draft requests the partnership’s “Street Address.” Current Schedule K-1 requests the partnership’s “Address.” Is any substantive change intended? If so, then why? What if the partnership uses a post office box as its main address?

Line 3. We suggest adding at the end of the existing language “taxable as a partnership” so that Line 3 reads, “Check if this is a publicly traded partnership (PTP) taxable as a partnership.” A PTP taxable as a corporation under Code Section 7701 or 7704 would not issue Schedules K-1 (Form 1065).

Line 4. The language does not readily identify the “PTP information” being sought. Why is this line needed?

Line 6. To what “tax shelter information” does Line 6 refer? Presumably, a partnership would check box 6 if it has engaged in a “reportable transaction.”

Part II

Line 8. The Vision Draft requests the partner’s “Street Address.” Current Schedule K-1 requests the partner’s “Address.” Is any substantive change intended? If so, then why? What if a partner uses a post office box as the partner’s main address?

Line 9. The Vision Draft provides a box to indicate “limited liability member.” The corresponding box on current Schedule K-1 designates a “limited liability company member.” Is any substantive change intended? If so, then why? Which box would a member of a limited liability partnership (LLP) check?

Line 11. Potentially misleading, this question implies that every partner is an “entity.” Current Schedule K-1 raises the same issue. Consider substituting, “If partner an entity, what type?”
Line 12. Consider adding the word “Net” so that the question requests the “Partner’s Share of Net Profit, Loss, Capital.” This addition would clarify that the question seeks the percentages in which the partner shares the partnership’s “residual” or “bottom line” profit and loss.\textsuperscript{16}

Line 13. The Vision Draft requests the partner’s share of “Recourse” liabilities. Current Schedule K-1 requests the partner’s share of “Other” liabilities.\textsuperscript{17} We endorse the change in the Vision Draft. Under Subchapter K of the Code, liabilities are characterized as either “nonrecourse” or “recourse.”\textsuperscript{18}

The existing instructions state that a partnership generally should enter the partner’s share of liabilities as of the end of the year. If, however, the partner terminated his or her interest in the partnership during the year, then the instructions direct the partnership to enter the share that existed immediately before the total disposition.\textsuperscript{19} We recommend that the IRS also consider requiring a partnership to report a partner’s share of liabilities immediately before the partner’s interest in the partnership is reduced other than by total disposition. With that information, the partner’s gain or loss (if any) on the reduction could be more readily calculated.

Line 14. We find this “vertical” presentation more intuitive than the “horizontal” Analysis of Partner’s Capital Account on current Schedule K-1.\textsuperscript{20} See also the preceding comments under the heading “IV. Partner Capital Accounts.”

Part III

Line 15. We recommend that the instructions for Line 15 limit this line to ordinary income (loss) “from trade or business activities.” Compare line 1 of current Schedule K-1.

The Instructions for Line 15 direct that passive income be reported on Schedule E, line 27(h). The passive income also may have to be reported on Form 8582.

We recommend that the K-1 Instructions explain where to report self-charged interest on certain lending transactions between a partner and a partnership. In general, self-charged interest is treated as passive income.\textsuperscript{21}

Lines 16 and 17. The instructions for these lines helpfully distinguish “net income” from “net loss” situations and their different reporting consequences on partners’ returns. Compare current Schedule K-1, lines 2 and 3, which do not as clearly portray those distinctions.

Line 18. The instructions’ cross reference to Schedule E suggests that this line includes only guaranteed payments for services. See also the Partner’s Instructions for Schedule K-1 and the Instructions for Form 1065, both of which refer to, “for example, guarantee payments for personal services.”\textsuperscript{22} Where should guaranteed payments for the use of capital be reported? See also the following comment about Line 19.

Line 19. Does “Interest” include guaranteed payments for the use of capital? The answer appears to be yes.\textsuperscript{23}
Line 20. The instructions for this line cross reference Form 1040 Schedule B. Presumably, in view of the Jobs and Growth Tax Relief Reconciliation Act of 2003 ("2003 Act"), the instructions for Schedule B will explain what the term “dividends” includes and does not include.

Line 22. We recommend that Line 22 refer to “Net” short-term capital gain (loss). Compare current Schedule K-1, line 4d.

Line 23. The 2003 Act eliminated the special rates applicable to qualified five-year gain. Accordingly, we recommend eliminating Line 23D and its instructions.

Line 24. We recommend that Line 24 refer to “Net” Section 1231 gain (loss). Compare current Schedule K-1, line 6.

Line 25. We recommend eliminating the “Note” in the instructions. The first sentence in the Note could mislead users because information reported on various other lines also may find its way to Schedule E. For example, information reported on Form 8582 (see e.g., Lines 16 and 17) also may flow to Schedule E. The second sentence of the Note may mislead users because items reported on various other lines also may relate to a passive activity loss or PTP.

Line 26. We recommend that the K-1 Instructions explain that “Money” includes either cash or marketable securities.

Line 28C. What does “Other Tax Exempt Income” include? Does the term include “tax deferred” income such as cancellation of indebtedness (“COD”) income excluded under Code Section 108? Alternatively, should COD income be reported on Line 28H, “Cancellation of Debt”?

The instructions for Line 28C refer to a “Memo entry”. What is a Memo entry?

Lines 28E and 28F. The instructions direct partners to report both of these items on Form 1040 Line 61. Could not Lines 28E and 28F be combined and any separate components under Code Sections 453(l)(3) and 453A(c) be identified in an attached schedule?

Line 28K. What does “Other Portfolio Income (Loss)” include? Does it include all other portfolio income other than investment income reported on Line 28A?

Line 29K. The instructions refer to a “Memo entry”. What is a Memo entry?

Line 29Q. Does this line include a partnership’s deductible contributions to pensions and IRAs?

Line 30. By listing numerous credits that a partnership may pass through to partners, the Vision Draft improves on current Schedule K-1. We do suggest expanding the instructions for Line 30 in one respect. Under Code Section 469, credits from rental activities (other than rental real estate activities) may be treated differently than credits from other activities. Current Schedule K-1 distinguishes the two categories. Similarly, we recommend that Line 30 provide separate letters for “Other Rental Credits” and “Other Credits.”
Line 31A. How should a partnership report foreign transactions from more than one
country or possession? The same issue may arise on current Schedule K-1.\textsuperscript{30}

Line 31Q. What information should be reported on this line?

Line 33D. Presumably, “Other Information” includes any information not reported
elsewhere.\textsuperscript{31} Would other information include special basis adjustments under Code Sections
732(d), 734(b), and 743(b)? Current Schedule K-1 and its instructions do not appear to explain
where to report these items. We recommend that the K-1 Instructions explain how partnerships
should report these basis adjustments on the revised Schedule K-1.\textsuperscript{32}

\begin{enumerate}
\item Instructions for Form 1065 (2002), page 32.
\item The IRS listed the advantages as follows:
\begin{itemize}
\item Familiar format for investors
\item Specific coding for distributive items
\item Simplified instructions
\item Alerts investors to supplemental instructions
\item Processing advantages
\end{itemize}
\item The Partner’s Instructions for Schedule K-1 currently read as follows: “Where ‘attach schedule’ appears beside a
line item on Schedule K-1, see either the schedule that the partnership has attached for that line or line 25 of
Schedule K-1.”
\item The IRS listed four reasons for not adopting a separate Schedule K-1 EZ:
\begin{itemize}
\item “Switchers”
\item Maintenance of two forms
\item Found a way to make it EZ for everyone
\item Single format recommended
\end{itemize}
\item For example, separate Schedule K-1 EZ forms could be provided for (1) an operating partnership with a trade or
business, (2) a real estate partnership, and (3) an investment partnership not conducting a trade or business. Each of
these schedules could be limited to the four or five lines most often used by that type of partnership.
\item Reg. Section 1.704-1(b)(2)(iv)(a).
\item See, principally, Reg. Section 1.704-1(b)(2)(iv)(g).
\item Instructions for Form 1065, page 32.
\item Partner’s Instructions for Schedule K-1 (Form 1065) (2002), page 2.
\item See current Schedule K-1, question I.
\item Partner’s Instructions for Schedule K-1, page 1.
\item Reg. Section 301.6109-1(a)(1)(ii)(C) states that any person other than an individual (such as a partnership)
required to furnish a taxpayer identifying number must use an employer identification number. See also the
Instructions for 1065, page 22, which state: “For an individual partner, enter the partner’s social security number
(SSN) or individual taxpayer identification number (ITIN). For all other partners, enter the partner’s EIN.”
\end{enumerate}
13 See Reg. Section 1.6011-4.

14 See current Schedule K-1, question A.

15 See current Schedule K-1, question B. The Instructions for Form 1065, page 22, instruct, “State on this line whether the partner is an individual, a corporation, an estate, a trust, a partnership, an exempt organization, or a nominee (custodian).”

16 See Code Section 702(a)(8).

17 See current Schedule K-1, question F.

18 See Reg. Section 1.752-1(a).

19 Instructions for Form 1065, page 22.

20 See current Schedule K-1, question J.

21 See Reg. Section 1.469-7.

22 See also Reg. Section 1.469-2(e)(2)(ii).

23 See Reg. Section 1.469-2(e)(2)(ii); Reg. Section 1.469-7(a)(1); General Counsel’s Memorandum 38133 (October 10, 1979); and General Counsel’s Memorandum 36702 (April 12, 1976).

24 See 2003 Act, Section 301(b)(1), amending Code Section 1(h).

25 See the Partner’s Instructions for Schedule K-1, page 10.

26 Compare current Schedule K-1, lines 4a-f, and the Instructions for Form 1065, page 23. See also the “Caution” about investment income and expenses in the Partner’s Instructions for Schedule K-1, page 9.

27 Compare the Partner’s Instructions for Schedule K-1, page 8.

28 Note, however, that numerous credits are listed in the Partner’s Instructions for Schedule K-1, pages 8-9.

29 See current Schedule K-1, Lines 12 and 13.

30 See current Schedule K-1, Line 17.

31 Compare Line 25 of current Schedule K-1 and its Instructions.

32 See Reg. Section 1.743-1(k)(1) and Reg. Section 1.732-1(d)(5).