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BASIS REPORTING: Reduce Taxpayer Burden and Improve Tax Compliance by Requiring Partnerships and S Corporations to Report Each Partner's or Shareholder's Adjusted Basis Annually on Schedules K-1

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*

PROBLEM

Pass-through entities determine their income, gain, and loss at the entity level, but these items are passed out and taxed at the partner or shareholder level at the owner's income tax rate. Partnerships and S corporations are two common types of pass-through entities, which are becoming the preferred way to structure businesses. Between 1980 and 2012, the number of pass-through business tax returns increased by approximately 294 percent, from nearly two million returns to about 7.6 million returns.² By comparison, the number of returns filed by C corporations, which are not pass-through entities, decreased by about 25 percent.³

Owners of pass-through entities often hold their interest for long periods of time. When the interest in the pass-through entity is sold or liquidated, the IRS requires partners or shareholders to compute their tax basis to determine the amount of gains or losses.⁴ These computations are some of the most complex in the Internal Revenue Code (IRC).

Each year, partnerships and S corporations are required to furnish Schedule K-1s to each partner or member, reporting their allocable share of income, gain, or loss, and file a copy with the IRS.⁵ The Schedule K-1 does not include the partner or shareholder's annual adjusted basis in the partnership or S corporation; rather, a worksheet accompanies the instructions to assist the recipient with the calculation.⁶ Taxpayers often lack the specialized knowledge required to accurately calculate basis, which results in errors and can lead to an overstatement of basis or an overpayment of tax.

¹ See Taxpayer Bill of Rights, available at www.TaxpayerAdvocate.irs.gov/taxpayer-rights.

² IRS, Statistics of Income (SOI) Tax Stats – Integrated Business Data, *Business Tax Statistics, 1980-2012*, Table 1, available at <https://www.irs.gov/uac/SOI-Tax-Stats-Integrated-Business-Data>. IRS data may double count some businesses because some private partnerships can be owned by one or more other business entities. The number of S corporation and partnership returns filed in 1980 was 1,925,043 and in 2012 the number of returns was 7,594,013.

³ *Id.*

⁴ IRC §§ 704, 1366.

⁵ IRC § 6031(b).

⁶ See IRS, *Partnership Schedule K-1 (2013)*; IRS, *Shareholder's Schedule K-1 (2013)*; IRS, *Partner's Instructions for Schedule K-1 (2013)*; IRS, *Shareholder's Instructions for Schedule K-1 (2013)*.

EXAMPLE

Pat and Sam form an equal partnership by contributing property of equal fair market value. Pat contributes \$40,000 cash plus assets having an adjusted basis of \$200,000 at the time of contribution. In addition, Pat transfers a mortgage on one of the assets of \$80,000. Pat's beginning basis in his partnership interest is \$200,000. Pat's basis is reduced by the \$80,000 mortgage he transferred, but it is increased by \$40,000, his share of the mortgage once it was transferred to the partnership.

Pat's adjusted basis of assets contributed:	\$	200,000
Plus cash contributed:	\$	40,000
Less mortgage liability transferred:	\$	(80,000)
Plus partnership debt assumed:	\$	40,000
Pat's initial basis:	\$	200,000

Continuing with the above scenario, Sam contributes assets with a basis of \$200,000 and a mortgage balance of \$60,000. Sam's basis in the partnership is \$210,000. Sam increases his basis by the 50 percent share of the \$80,000 mortgage transferred by Pat. In addition, Pat has a new basis of \$230,000 (\$200,000 plus \$30,000) because he increases his basis by his 50 percent share of the \$60,000 mortgage contributed by Sam.

Sam's adjusted basis of assets contributed	\$	200,000
Plus cash contributed:	\$	0
Less mortgage contributed:	\$	(60,000)
Plus partnership debt assumed (Sam):	\$	30,000
Plus partnership debt assumed (Pat):	\$	40,000
Sam's initial basis:	\$	210,000
Pat's initial basis:	\$	200,000
Plus partnership debt assumed (Sam):	\$	30,000
Pat's revised initial basis:	\$	230,000

If the partnership was organized as an S corporation, the calculations would be slightly different.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that due to the complexity of pass-through basis computations and the inconsistent reporting of adjusted basis, Congress should require annual adjusted basis reporting on Schedule K-1s issued to each partner or shareholder.

PRESENT LAW

Determining the correct tax basis for pass-through entities is no easy task. Subchapter K,⁷ which covers partnership⁸ taxation, contains some of the most complicated computations in the IRC. It is closely followed in complexity by the sections pertaining to computing the tax basis for an S corporation interest in Subchapter S.⁹

There are several sections of the IRC that determine a partner's tax basis in a partnership. Each partner must calculate his or her basis in the partnership using two separate methods. First, the partner must determine his basis in the partnership interest, commonly referred to as "outside" basis.¹⁰ Outside basis is adjusted annually to reflect the income, gains, and losses from the operation of the partnership. Second, the partner must determine his share of the partnership's basis in the partnership's assets (net of liabilities), commonly referred to as "inside" basis.¹¹ A partner's inside basis is maintained in a capital account and generally differs from the partner's outside basis in that the capital account does not reflect a partner's share of partnership liabilities, or optional basis adjustments under IRC § 754. These different types of basis can result in confusion and misreporting.

When a partner contributes property into a partnership in exchange for a partnership interest, the general rule is that a partner has a tax basis in the partnership interest equal to the adjusted tax basis of the assets

7 IRC §§ 701-77.

8 A partnership is the relationship existing between two or more persons who join together to carry on a trade or business. Each person contributes money, property, labor, or skill and expects to share in the profits and losses of the business. A partnership must file an annual information return to report the income, deductions, gains, losses, etc., from its operations, but it does not pay income tax. Instead, it "passes through" any profits or losses to its partners in accordance with the partnership agreement. Each partner includes his or her allocable share of partnership income or loss on his or her tax return. Partnerships organized in the United States, or derive income from operations in the United States, are required to file Form 1065, *U.S. Return of Partnership Income*. IRC § 6031(a).

9 IRC §1361. S corporations are corporations that elect to pass income, losses, deductions, and credits through to their shareholders for federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level. To qualify for S corporation status, the corporation must meet the following requirements: (1) domestic corporation; (2) eligible shareholders (e.g., individuals, certain trusts, and estates are eligible shareholders and partnerships, corporations or non-resident alien are ineligible shareholders); (3) no more than 100 shareholders; (4) one class of stock. Certain corporations are ineligible to elect to be an S corporation including certain financial institutions, insurance companies, and domestic international sales corporations. IRC §§ 1361-78. Government Accountability Office (GAO), GAO-10-195, *Tax-Gap: Actions Needed to Address Noncompliance With S Corporation Tax Rules* 16 (Dec. 2009). "S corporation stakeholder representatives told us that calculating and tracking basis was one of the biggest challenges in complying with S corporation rules." Curtis J. Berger, *W(h)ither Partnership Taxation?* 47 *Tax L. Rev.* 105, 108 (1991) ("In order to keep tax planners from wholly abusing the partnership's privileged status, while not denying them all remaining flexibility, Congress and Treasury [fashioned] a statutory and regulatory apparatus which [is] one of the most inaccessible and burdensome features of the entire tax system."). Burgess J. W. Raby & William L. Raby, *S Corporation AAA and OAA- Alphabet Soup or Taxpayer Stew?*, 78 *Tax Notes* 1013 (Feb. 23, 1998) (describing Subchapter S as "remarkably complicated"). Andrea Monroe, *Integrity in Taxation: Rethinking Partnership Taxation*, 64 *ALA. L. REV.* 289, 316 (2012) ("Congress's desire to provide partnerships with flexible allocation provisions, coupled with the line drawing that such an approach requires, has burdened partnerships with enormous complexity. Under the substantial economic effect safe harbor, a partnership must apply multiple layers of intricate, mathematical provisions to every allocation it makes, every year."). James Alm & Jay A. Soled, *Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance*. 40 *Ohio N. U. L.* 693, 699 (2014) ("In the area of tax law, courts, academicians, practitioners, and students generally agree that Subchapter K (the subchapter that details partnership taxation) and the Treasury regulations promulgated thereunder are extraordinarily complex.")

10 IRC §§ 722, 705.

11 IRC §§ 723, 704.

contributed to the partnership.¹² If a partner purchases a partnership interest, the partner will generally have a tax basis in the partnership interest equal to the purchase price of the interest.¹³

Once the partnership begins to conduct business, rules regarding partnership operation and partnership debt are applicable. IRC § 705 explains how a partner adjusts his basis in his partnership interest based on the entity's gains or losses and/or distributions.¹⁴

Similarly, computing S corporation tax basis is a daunting task. The initial basis in an S corporation is figured much like a partnership. IRC §§ 358 or 1012 govern at the inception of the S corporation.¹⁵ Taxpayers who acquire their S corporation investment by purchase are generally given a tax basis in their S corporation shares equal to the purchase price.¹⁶ Once operations begin, the tax basis goes through annual upward and downward adjustments based upon transactions.¹⁷ If an S corporation incurs debt, no tax basis adjustments are made to the taxpayer's interest.¹⁸ If a shareholder lends funds to an S corporation or personally guarantees an S corporation's debt, then the lending shareholder's will have an additional separate basis account equal to the loan or guarantee amount. A shareholder's basis attributable to loans or guarantees is only taken into account after the shareholder has reduced his tax basis to zero. The shareholder cannot reduce his basis, including his basis from the indebtedness, below zero, by loss and deduction items that flow through the S corporation.¹⁹

Partnerships and S corporations must file information returns (Forms 1065 and 1120-S, respectively).²⁰ Partnerships and S corporations generally do not directly pay taxes on the net income reported on Forms 1065 or 1120-S. Instead, they pass profits, losses, and gains to partners and shareholders, respectively, who pay any applicable taxes.²¹ Partnerships and S corporations are required to furnish Schedule K-1s to their partners or shareholders to report their allocable share of income, loss, or gain for the year and to file a copy with the IRS.²²

The Schedule K-1 for partnerships contains three parts: Part I (Information About the Partnership), Part II (Information About the Partner), and Part III (Partner's Share of Current Year Income, Deductions, Credits, and Other Items). The Schedule K-1 for S corporations mirrors the one for partnerships and has three parts. Both sets of instructions contain short sections pertaining to the calculation of

12 IRC § 722.

13 IRC § 742.

14 IRC § 705(a)(1). Basis adjustments increase for (a) the taxable income of the partnership; (b) income of the partnership exempt from tax; and (c) the excess of depletion deductions over the basis of the property subject to depletion. IRC § 705(a)(2). Basis adjustments decrease (but not below zero) for (a) partnership distributions; (b) partnership losses; (c) partnership expenditures not deductible in computing its taxable income and not properly chargeable to the taxpayer's capital account; and (d) any partnership oil and gas property, by the amount of the partner's deduction for depletion, to the extent that such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such property.

15 IRC §§ 358, 1012.

16 IRC § 1012(a).

17 IRC § 1367.

18 IRC § 1366.

19 IRC § 1367(d)(1)(B).

20 IRC §§ 6031, 6037.

21 IRC § 701.

22 IRC §§ 6031, 6037; Treas. Reg. §§ 1.6031(a)-1, 1.6037-1.

a partner's or shareholder's basis in the partnership interest or stock along with a worksheet to assist with calculations.²³

REASONS FOR CHANGE

Taxpayer Burden

The explosion of growth of pass-through entities as a chosen business structure combined with the complexity of the laws and regulations governing basis computations create a situation where many taxpayers face some of the most complex sections of the IRC.

Partners and shareholders of pass-through entities may hold onto their interest for many years and fail to keep adequate records of the annual changes. Even when shareholders and partners do keep complete records, the process of computing basis changes is exceedingly complex and challenging, which is overwhelming to taxpayers. Upon sale or dissolution of their interest in a pass-through entity, taxpayers face a risk for either an overstatement of basis, with a corresponding underpayment of tax, or an understatement of basis resulting in an overpayment of tax. In some larger partnerships, there are many partners trying to independently calculate their basis with their own preparers.

Revenue Protection

In March 2012, the IRS released a working paper that highlights the growing magnitude of the tax gap.²⁴ The results further support an earlier paper and prior research study findings — when transactions are subject to information reporting to the government, tax compliance is generally very high.²⁵ However, when transactions are not subject to information reporting to the government, the tax compliance rate drops tremendously.²⁶

This change will increase tax compliance by eliminating the ability of partners and S corporation shareholders to overstate their basis and thereby not pay the correct amount of tax. Requiring the annual reporting of adjusted basis on the Schedule K-1 for pass-through entities will further help taxpayers to understand their basis and not pay an incorrect amount of tax. It will also serve to assist taxpayers keep accurate records of their basis and eliminate the need to reconstruct basis many years down the road when many complex adjustments have been made.

In an article written in 2014, Professors James Alm and Jay A. Soled estimated that noncompliance in the pass-through entity basis reporting results in an annual revenue loss of approximately \$8 billion.²⁷ Pass-through entity basis reporting requirements would assist with the collection of this annual revenue loss, while reducing burden and minimizing complexity for taxpayers.

23 See IRS, *Partnership Schedule K-1 (2013)*; IRS, *Shareholder's Schedule K-1 (2013)*; IRS, *Partner's Instructions for Schedule K-1 (2013)*; IRS, *Shareholder's Instructions for Schedule K-1 (2013)*.

24 IRS, Office of Research, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* (Mar. 2012).

25 IRS, Office of Research, *Year 2001 Federal Tax Gap* (Feb. 2007); IRS, *IRS Releases New Tax Gap Estimates; Compliance Rates Remain Statistically Unchanged from Previous Study*, IR-2012-4 (Jan. 6, 2012). See also GAO, GAO-06-603, *Capital Gains Tax Gap* (2006).

26 IRS, Office of Research, *Federal Tax Compliance Research: Tax Year 2006 Tax Gap Estimation* (Mar. 2012).

27 See James Alm & Jay A. Soled, *Tax Basis Determinations, Pass-Through Entities, and Taxpayer Noncompliance*, 40 Ohio N. U. L. 693, 721 (2014).

EXPLANATION FOR RECOMMENDATIONS

Requiring pass-through entity basis reporting annually on the Schedule K-1 is a win-win proposition for taxpayers and the government. Taxpayers will no longer have to struggle with reconstructing their basis while following the complex adjustment rules, and the government will be able to collect the proper amount of tax due and better monitor compliance.

Similar to the changes for reporting adjusted stock basis enacted in 2008, pass-through entity basis reporting will reduce the recordkeeping burden on partners and S corporation shareholders seeking to report their tax basis accurately.²⁸ By centralizing basis reporting with third-party preparers, the burden for accurately calculating basis lies with those who have the expertise and resources to do so. Pass-through entities employ bookkeeping services that keep the necessary information regarding basis adjustment, and it is less burdensome for the third-party preparer to issue the annual statement.

Additionally, the Government Accountability Office (GAO) found that the full extent of partnership and S corporation income misreporting is unknown. The IRS's last study of S corporations, using 2003-2004 data, estimated that these entities annually misreported about 15 percent (an average of \$55 billion for 2003 and 2004) of their income. Using IRS data and the study results, the GAO derived an estimate of \$91 billion per year of individuals misreporting partnership and S corporation income for 2006 through 2009.²⁹

In writing regulations to require annual reporting of basis, there are some technical issues.³⁰ One issue involves how reporting would work in light of private party sales. Presently, there is no requirement to notify the IRS when interests in pass-through entities are bought and sold. If one of the 25 partners sells his partnership interest to a third party, the third party's initial basis will be what he paid. Because this is a private transaction, the partnership may not be privy to the sales price. If the partnership does not or cannot know the taxpayer's basis due to origination of the partnership interest either through gift or private party sale, an exception could be created to the pass-through entity basis reporting requirement. The K-1 would note that the basis calculation does not include the original purchase or gift basis of the partnership interest and only includes adjustments since that time.

A second issue involves how much additional work and change in programming to the electronic software packages the annual reporting of pass-through entity basis would require. The technology for electronic preparation and bookkeeping software already exists. Bookkeepers, Certified Public Accountants, and tax attorneys are already maintaining much of the information that individual partners are supposed to be keeping records of annually. There would be a cost and time needed for updating of the software and change in record keeping methods. The burden on preparers could possibly be mitigated by a phased in approach either by tying the reporting to assets or numbers of partners while being phased in over a period of several years.

28 IRC § 6045. Prior to the passage of IRC § 6045(g), taxpayers were required to determine basis for their marketable securities. Many, including the National Taxpayer Advocate, have argued that this resulted in an overly burdensome hardship for taxpayers. See National Taxpayer Advocate 2005 Annual Report to Congress 433-39.

29 GAO, GAO-14-453, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance* (May 14, 2014).

30 The National Taxpayer Advocate discussed with many individuals including persons who prepare or advise on pass-through entity returns in developing the concerns and issues regarding this legislative recommendation.

The National Taxpayer Advocate believes these technical issues, while challenging, are resolvable and that an annual basis reporting requirement ultimately benefits all parties in pass-through entities, especially partners who face challenges in computing their adjusted basis to pay no more than the correct amount of tax.