Tax Insights & Commentary
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Redefined Partnership Liabilities Will Require Close Scrutiny

The IRS's planned changes to categorizing and reporting partnership liabilities are more consequential than they appear because of how they would affect several tax rules, says Marcum's Michael D'Addio.

Adrienne Mikolashek, the IRS deputy associate chief counsel for passthroughs and special industries, revealed potential alterations to the 2023 partnership tax returns in a recent American Bar Association tax meeting. She indicated that Form 1065, the US Return of Partnership Income—specifically Schedule K-1, Part II, item K—would likely demand more comprehensive information regarding partnership liabilities.

Traditionally, partnership liabilities have been split into three categories: recourse, nonrecourse, and qualified nonrecourse liabilities. However, Mikolashek hinted at an evolution of this approach for the 2023 tax year. There may be a requirement for the partnership to further dissect recourse liabilities, distinguishing between the components attributable to a deficit restoration obligation and the portion arising due to partner guarantees of partnership debt.

This potential change in reporting requirements aims to give partners more detailed insights into their possible obligations relating to the partnership's liabilities that support the allocation of recourse debt. This could galvanize partners who receive K-1s to contest the partnership if they perceive these economic responsibilities as erroneously calculated.

After this meeting, the IRS released a draft of the 2023 Form 1065 and its Schedule K-1. Notably, Schedule K-1 doesn't demand a breakdown of the allocated recourse liabilities—they continue to be classified into the three familiar categories in Part II, item K1.

However, the form introduces a new question, K3, that must be affirmed if any previously mentioned liabilities carry guarantees or other payment obligations by the partner. The specifics of this new requirement are unclear, as no instructions have been provided with the draft form.

To the untrained eye, the portion of Schedule K-1 that deals with liability allocation might seem inconsequential. This couldn't be further from the truth. While these appear as minor informational items, this section's data profoundly impacts the partners and the partnership, especially when considering several tax rules that depend on the partner's adjusted basis in its partnership interest.

These classifications of liabilities, nonrecourse, qualified nonrecourse, and recourse aren't merely legal jargon. They're crucial to determining the nature of the debt held by the partnership.

For instance, nonrecourse liabilities are those where no partner bears the economic risk of loss, while qualified nonrecourse liabilities often refer to nonrecourse debt connected with holding real property. However, only qualified nonrecourse liabilities contribute to a partner's at-risk amount under Section 465 of the tax code.

Recourse liabilities typically signify situations where a partner bears the economic risk of loss. This might arise in cases of deficit restoration obligations or when a partner acts as a guarantor for certain partnership liabilities. Whether a debt is labeled as recourse often can depend on the nature of the tax partnership, such as whether it's a general partnership, limited partnership, or limited liability partnership or company.

The precise allocation of liabilities isn't just a matter of correct bookkeeping. It carries immense significance because it affects numerous tax rules, including those codified in Sections 704(d), 731, and 704(b). These govern a partner's use of allocated partnership losses; the tax-free distribution of money from the partnership to a partner; and the allocation of income, gain, loss, deductions, and credits by the partnership to its partners.

In summary, Mikolashek's announcement of potential changes to Form 1065 for 2023 underscores the complex nature of partnership debt allocation. It also underlines the myriad tax consequences that partners can face, which can be significant if liabilities are miscategorized or misallocated.

Consulting with experienced tax counsel before the K-1s are issued is crucial. As we await the final draft of Form 1065, it's essential to recognize that this remains a highly technical area requiring detailed scrutiny.

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