



01.30.2023

FTB NOTICE - 2023 - 01

SUBJECT: Capital Account Analysis Tax Basis Methodology for Schedule K-1 (565) and Schedule K-1 (568) for Taxable Years 2021, 2022, and Subsequent Tax Years

PURPOSE:

To clarify the reporting requirements for the “Analysis of partner's tax basis capital account” on Schedule K-1 (565) and Schedule K-1 (568) for taxable years 2021, 2022, and subsequent tax years.

BACKGROUND:

Beginning taxable year 2004, the Internal Revenue Service (IRS) allowed partnerships to report the analysis of their partners' capital account under one of four alternative methods: "Tax basis," "GAAP," "Section 704(b) book," or "Other (explain)." Such analysis was provided on each partners' Schedule K-1 (Form 1065).

Beginning taxable year 2006, the Franchise Tax Board (FTB) modified the Schedule K-1 (565) and Schedule K-1 (568) to mirror the federal Schedule K-1 (Form 1065), for an entity taxed as a partnership to report the method utilized to analyze its partners' or members' capital accounts, i.e. "Tax Basis," "GAAP," "Section 704(b) book," or "Other (explain)." For California tax purposes, per the instructions for Form 565 and Form 568, taxpayers are required to use worldwide amounts determined under California law to complete their Form 565 and Form 568, along with their supporting schedules. Therefore, when a partnership indicated the tax basis method by checking the "Tax Basis" box on either Schedule K-1 (565) or Schedule K-1 (568), the number reported in the “Analysis of partner's capital account” was the California amount, and not the federal amount.

Beginning taxable year 2019, the IRS eliminated the options in which a partnership was allowed to report its partners' capital accounts from the Schedule K-1 (Form 1065); however, a partnership could still use the previously listed methods, per the 2019 Instructions for Form 1065 and IRS Notice 2019-66. Beginning taxable year 2020, a partnership was required to use the tax basis method—as defined in the federal instructions—for reporting its partners' capital accounts for federal income tax purposes.



Beginning taxable year 2021, the FTB follows the changes made to the federal Schedule K-1 (Form 1065), and requires an entity taxed as a partnership to report its partners' or members' capital accounts on the Schedule K-1 (565) and Schedule K-1 (568) using the same tax basis method as described in the 2021 Instructions for Form 1065, but calculated under California law.

On March 8, 2022, the FTB issued FTB Notice 2022-1 which allowed taxpayers, for the 2021 taxable year, who files Form 565 or Form 568 to report its partners' or members' capital accounts on Schedule K-1 (565) or Schedule K-1 (568) using the tax basis method as determined under federal law, as reported on Schedule K-1 (Form 1065), or by using the tax basis method as determined under California law. The Notice stated that beginning taxable year 2022 and for every taxable year thereafter, the FTB will require a taxpayer who files Form 565 or Form 568 to report its partners' or members' capital accounts on the Schedule K-1 (565) and the Schedule K-1 (568) using the tax basis method as determined under California law.

The Franchise Tax Board has become aware that certain persons required to file Schedule K-1 (565) and Schedule K-1 (568) may be unable to timely comply with the requirement to report partner capital on the tax basis method as calculated under California law for 2022.

PROCEDURE

For taxable years 2021 and 2022, the FTB will permit a taxpayer who files Form 565 or Form 568 to report its partners' or members' capital accounts on Schedule K-1 (565) or Schedule K-1 (568) using the tax basis method as determined under federal law, as reported on Schedule K-1 (Form 1065), or by using the tax basis method as determined under California law. However, this is limited solely to the capital account analysis on Schedule K-1 (565) and Schedule K-1 (568) for the taxable years 2021 and 2022, and does not allow taxpayers to use their federal tax basis in lieu of their California tax basis for any other purpose, including reporting or determining their California tax liability.

Beginning taxable year 2023, and for every taxable year thereafter, the FTB will require a taxpayer who files Form 565 or Form 568 to report its partners' or members' capital accounts on the Schedule K-1 (565) and the Schedule K-1 (568) using the tax basis method as determined under California law. FTB's 2022 Form 565 and 568 instructions contain methods to compute the beginning tax basis capital account analysis balance for those filing these forms who did not previously calculate their tax basis capital account on Schedule K-1 (565) and Schedule K-1 (568) under California law including methods similar to those the IRS permitted in its 2020 Form 1065 instructions.

PRIOR GUIDANCE

This Notice supersedes and replaces FTB Notice 2022-1.



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