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November 1, 2007

Ms. Linda E. Stiff  
Acting Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, D.C. 20024

By e-mail: [\\*irs.commissioner@irs.gov](mailto:*irs.commissioner@irs.gov)

**Re: Recommendation to Improve Tax Reporting Related to Forms 1040 Filed on  
Extension and Schedules K-1 from Partnership Returns**

The New York State Society of Certified Public Accountants, representing 30,000 CPAs in public practice, industry, government and education, submits the following recommendation to you regarding the above-cited taxation issue. NYSSCPA thanks the Internal Revenue Service for the accepting these comments.

The NYSSCPA Taxation of Individuals Committee deliberated the practice problems referred to herein on behalf of tax preparers, taxpayers and the government. If you would like additional discussion with the committee, please contact William H. Jones, chair of the Taxation of Individuals Committee, at (212) 503-6363, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,



David A. Lifson  
President

Attachment



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**RECOMMENDATION TO IMPROVE TAX REPORTING RELATED TO  
FORMS 1040 FILED ON EXTENSION AND SCHEDULES K-1 FROM  
PARTNERSHIP RETURNS**

**November 1, 2007**

**Principal Drafter**

**William H. Jones**

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# **New York State Society of CPAs**

## **Recommendation to Improve Tax Reporting Related to Forms 1040 Filed on Extension and Schedules K-1 from Partnership Returns**

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### **SUMMARY OF THE RECOMMENDATION**

Currently, the extended due dates for filing Form 1040 for calendar year taxpayers and for filing Form 1065 with associated Schedules K-1 for calendar year flow-through entities coincide, typically on October 15. Many 1040 returns require K-1 information so that they can be complete, accurate and filed in a timely manner. The evident and frequent predicament is that the required K-1 information is sometimes not available until the time the 1040 is due, because the deadline that most taxpayers regard as sacrosanct is the IRS's deadline. We need your help. We recommend that the extended due date for Form 1065 be moved ahead to September 15.

### **OVERVIEW OF CURRENT AND PAST PRACTICE**

#### **Tax Filing Deadlines**

As nearly every U.S. citizen knows, individual federal tax returns are due April 15 (unless it falls on a weekend or holiday in which case the returns are due the next business day).

Beginning with 2005 returns due in 2006, individuals may use a single IRS form (Form 4868) for an automatic six-month extension of time to file. This replaced the previous two-step process under which an automatic extension was granted for four months (generally until August 15), and additional time to file was requested on a second extension request form (Form 2688) for two more months (generally until October 15).

At the time, according to the Internal Revenue Service (IRS), approximately 8 million individual taxpayers requested the initial four-month extension, and nearly a third of those requested a second extension.

Corporations could request an automatic six-month tax-filing extension, and the new regulations extended this option to most non-corporate business taxpayers, including partnerships and trusts. Calendar-year corporation returns are generally due on March 15; calendar-year partnerships and trust returns are generally due April 15, before extensions.

According to the IRS, as of October 5, 2007, many of the more than 10.2 million taxpayers who requested an automatic six-month extension this year had yet to file.

### **Schedules K-1**

Most partnerships, as pass-through entities, do not pay federal income tax. A partnership must file an annual information tax return with the IRS (Form 1065) in which it reports all items of taxable income and deductions. This filing includes Schedules K-1 ("K-1s") that detail each partner's respective share of taxable income and deductions. Partners pay tax on their distributive share of partnership income (or deduct a loss) on their personal federal income tax return (regardless of whether the partnership profits were actually distributed to them).

### **Proliferation of Partnerships & Hedge Funds**

Only a decade ago, alternative investment vehicles operating as partnerships were a mere token number compared to their current magnitude. Thousands of hedge funds have started up in just the past five years. Originally, these funds were designed for sophisticated investors with millions of dollars, but they have evolved to offer opportunities to much smaller investors (say, with \$100,000 to invest), further escalating the volume of K-1s generated. Furthermore, in the past 10 years, the LLC treated as a partnership for federal income tax purposes has been the significant preference as the choice of entity for start-up businesses.

Also, as part of this overall proliferation of partnerships in the economy, tiered partnerships have become common, which makes the simultaneous due date problem for the ultimate individual owners even worse, because the upper tier partner can not close its books and report to its partners until the lower tier partner provides a K-1. The chain is only as timely as its latest link.

The final extended reporting deadline for all of these entities to issue K-1s to their investors is October 15. Individual investors must report income derived from these flow-through entities, and must do so by October 15.

Coincidence, more than design, has landed the final extended individual federal income tax return deadline and the final extended partnership return deadline on the same date.

## **ECONOMIC AND REGULATORY CHANGES HAVE CREATED SIGNIFICANT REPORTING ISSUES**

### **The Deadlines Coincide**

In town hall meetings held by the Society across the State of New York, CPA practitioners are clamoring for the IRS to provide a solution to a long-standing and rapidly escalating practice frustration related to the coinciding filing

deadlines. As noted earlier, generally federal individual tax returns on automatic extension are due to be filed on October 15 (six months after their original due date of April 15)—the same date that critical income and deduction information necessary to prepare those returns is due from partnership returns and related entities.

The so-called tax “busy season” no longer revolves around the actual April 15 filing deadline; rather, it straddles April and October with one major exception: the tax returns finally due on October 15 have the added complexity of late or amended K-1s, and are, therefore, more problematic for the tax preparer, the taxpayer and the government.

Because an extension of time to file is not an extension of time to pay, taxpayers who invest in partnerships and alternative investments must calculate their tax due on April 15, based on imperfect information, and then recalculate and file on October 15, often at the last moment as K-1s are received. This imposes a greater burden on these taxpayers, in that both deadlines—April 15 and October 15—are critical calculation dates. Their preparation and planning are more complicated and more prone to error and delay.

### **The Problem with K-1s**

The number of K-1s issued by partnerships is voluminous, in part because the partnership form is preferred by many sophisticated investment entities. Generally, alternative investment vehicles use the partnership form, including hedge funds, private equity funds, venture capital funds and fund of funds (in addition to traditional investments such as real estate and oil and gas entities). In particular, foreign income sources related to Forms 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund), 926 (Return by a U.S. Transferor of Property to a Foreign Corporation) and 8845 (Indian Employment Credit), create additional, burdensome reporting requirements, as well.

Furthermore, many other entities are treated as partnerships for federal income tax purposes including limited liability companies (LLCs). Subchapter S corporations and estates and trusts issue K-1s as well. As the number of hedge fund and other alternative investments increases, a corresponding and sometimes exponential number of K-1s are issued.

Several conditions give rise to delays in the receipt of a Schedule K-1:

- A high volume needs to be prepared and issued;
- Extraneous issues such as foreign tax credits, passive activities and multi-state tax jurisdiction issues further complicate calculations;
- Underlying transactions are difficult;
- Tax treatment of particular items has not been determined in time;

- “Tiered” partnerships or trusts have created information “bottlenecks,” for example, a trust may be awaiting a partnership K-1 before it may issue K-1s to its beneficiaries, while the partnership awaits a K-1 from several alternative investments.

As a result, K-1s are often not available for distribution to partners until too close to the October 15 deadline; even when they are issued early, it is common for revised versions to follow. In many instances, the individual taxpayer’s return had been filed before the revised K-1 is issued, necessitating that an amended return be filed.

Investors in funds must plan to file an extension on April 15 and a final return on October 15. The automatic six-month extension is already a necessity in order to comply with their tax filing requirements.

This burden on taxpayers results in a delay through no fault of their own. These investors may have had no other reason for requesting an extension of time to file. Add to that, the likely delay in receipt of a K-1 or the seeming impossibility of meeting deadlines that coincide, and there is a situation that requires an immediate solution.

### **Unnecessary Complexity in Filing**

Complexity in investment reporting increases the cost of tax compliance for investors. Without the necessary K-1 information, tax preparers and taxpayers cannot accurately calculate estimated payments, extension payments and other year-end planning items.

Without the K-1 (or with a K-1 that is ultimately revised), these undesirable circumstances might exist:

- The accuracy of very complicated returns is compromised because preparers are not afforded as much time as they might be;
- Investors lose various benefits, such as the deduction for charitable contributions;
- Alternative Minimum Tax (AMT) is incurred due to actual K-1 information differing substantially from estimates;
- Taxpayers are met with increased tax return preparation fees due to avoidable complexity and the need to file amended returns;
- Unanticipated foreign and/or state income tax filing obligations arise;
- K-1s contain “surprises” such as the disclosure of a material item for which the tax treatment is unclear;
- State estimated payments or extension requests are missed;
- Penalties for late filing or underpayments are incurred;
- Required disclosure related to tax shelter reporting information is overlooked.

## **The Problem Persists and Worsens Unabated**

Tax reporting and compliance challenges do not end with the timing and receipt of the K-1. By nature, a K-1 is complex. There was a time in which a K-1 contained one number. Nowadays, many K-1s are ten pages long.

The problem will persist unless action is taken. Investors will continue to seek high return investments, thereby further increasing the number of partnerships and similar entities. Tax consequences will continue to become more complex because of activities involving specialized industries, commodities, foreign currencies and more. CPAs and taxpayers alike are warranted in becoming increasingly concerned over the inherent delays encountered in filing individual tax returns because they are awaiting K-1s from partnerships and others.

## **THE PROPOSED SOLUTION**

There is a straightforward solution to address all of these problems while improving reporting, compliance and efficiency.

The IRS should consider changing the extended due date for partnership tax returns to September 15. By moving the partnership tax return extended due date one month earlier, the filing system would be enhanced in several ways:

- Better, more accurate returns may be prepared;
- Fewer compliance issues might arise;
- Simpler, less complex practices will be in place.

More specifically, the IRS may anticipate the following improvements to the reporting system, should it enact this proposal:

1. Tax reporting would be improved because tax preparers would have completed the partnership returns by September 15, thus allowing substantially more time to be devoted to the accurate preparation of personal returns due October 15.
2. Unarguably, the proposed change would be revenue positive because personal returns would be completed sooner (as many balances due from taxpayers would be paid before October 15 rather than exactly on October 15).
3. More tax returns may be filed before October 15 thereby saving the IRS the extra costs incurred by the late "rush" of filings.
4. Taxpayers would be spared the cost of preparing amended tax returns that resulted from not receiving their K-1s early enough to be included in their tax returns. (Traditionally when this situation occurs, taxpayers estimated the amounts anticipated on their K-1s, and tax preparers were engaged to prepare amended returns well after October 15.)

Taxpayers and tax preparers (already accustomed to being responsive to deadlines), will be amenable to the September 15 partnership deadline, knowing that it alleviates the complications caused by the existing simultaneous due dates.

The only other option available to the IRS is to request that Congress make a legislative repair to extend the extended individual income tax return deadline another month to November 15. This, too, would solve the problems at hand, but is a less desirable solution because it would unnecessarily extend the 1040 filing season (spanning nearly the year), encourage a “later-rather-than-sooner” compliance atmosphere, and carries the complications associated with a legislative cure. We consider moving the extended due date of partnership returns ahead to September 15 the preferred option.

We thank the IRS for its consideration of this proposal.