FORM 1040 REPORTING OF SCHEDULES K-1

1999 Income Tax School

FORM 1040 REPORTING OF SCHEDULES K-1

A. INTRODUCTION

Schedules K-1 from limited liability companies (LLCs), partnerships, S corporations, and fiduciary tax returns are completed at the respective entity level and serve as the vehicles to transmit to the individual partner, shareholder, or beneficiary his or her share of entity income and expense. This Schedule K-1 data is then reflected on the personal income tax return of the individual.

It is important for tax practitioners not only to recognize how the Schedule K-1 information is to be reflected on the individual's tax return but also to understand the importance of basis considerations of members, partners, and S corporation shareholders. At times, the basis issue can become very complex and will require detailed record keeping at either the individual partner or S corporation shareholder level. To assist in this task, a worksheet for tracking shareholder basis is provided in this chapter.

Practitioner Note. If an LLC is taxed like a partnership, the members of the LLC are treated the same as partners in a partnership for purposes of Schedule K-1. Consequently, all of the discussion in this chapter regarding partners also applies to members of an LLC taxed as a partnership.

B. PARTNER SCHEDULE K-1

The practitioner first needs to review Questions A through J from the partner's Schedule K-1.

SCHEDULE K-1 (Form 1065)
Department of the Treasury
Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

► **See separate instructions.**

For calendar year 1999 or tax year beginning , 1999, and ending ,

OMB No. 1545-0099

1999

Partner's identifying number ► | **Partnership's identifying number ►**

Partner's name, address, and ZIP code | Partnership's name, address, and ZIP code

A This partner is a ☐ general partner ☐ limited partner
☐ limited liability company member

B What type of entity is this partner? ► ....

C Is this partner a ☐ domestic or a ☐ foreign partner?

D Enter partner's percentage of: **(i)** Before change or termination **(ii)** End of year

	(i) Before change or termination	(ii) End of year
Profit sharing	%	%
Loss sharing	%	%
Ownership of capital	%	%

E IRS Center where partnership filed return:

F Partner's share of liabilities (see instructions):
Nonrecourse . . . . $ ....
Qualified nonrecourse financing . $ ....
Other . . . . $ ....

G Tax shelter registration number . ► ....

H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . . ☐

I Check applicable boxes: **(1)** ☐ Final K-1 **(2)** ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	**(b)** Capital contributed during year	**(c)** Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	**(d)** Withdrawals and distributions	**(e)** Capital account at end of year (combine columns (a) through (d))
			( )	

Explanation

- **Question A.** A **general partner** is **personally liable** for partnership debts. A **limited partner's** personal liability for partnership debt is limited to his or her **individual investment** in the partnership. An LLC member can be either a general partner or limited partner.
- **Question B.** Fill in this line to indicate whether the partner is an individual, a partnership, a fiduciary, a corporation, an exempt organization, or a nominee.
- **Question C.** The "foreign" box will be checked only if the partner is a nonresident alien, foreign partnership, foreign corporation, or foreign estate or trust.
- **Question D.** A partner's percentage **ownership of capital** is that portion of capital the partner would receive if the partnership were liquidated at the end of the year. If a partner's interest is terminated during the year, the percentage that existed immediately before the termination should be entered on line D, column (i). When the profit- and loss-sharing percentages change during the year, the pre-change percentages will be reflected on line D, column (i), and the end-of-year percentage will be shown on line D, column (ii).
- **Question E.** This simply tells the preparer where the partnership (not the partner) files its partnership tax return.
- **Question F.** Each partner's share of the partnership liabilities is separated into "nonrecourse," "qualified nonrecourse financing," and "other" categories. **Nonrecourse loans** are liabilities of the partnership for which none of the partners have personal liability. **Qualified nonrecourse financing** consists of loans secured by real property used in an activity of holding real property that is subject to the at-risk rules. **Other** liabilities are obligations of the partnership for which the individual partner is responsible in his or her percentage amount.
- **Question G.** If the partnership is a tax shelter, the partner will be provided with a 15-digit number to enter on Form 8271.
- **Question H.** This box will be checked if the partnership is publicly traded.
- **Question I.** If applicable, a final Schedule K-1 or an amended Schedule K-1 will be checked.
- **Question J.** The reconciliation of the partner's capital account is very helpful to the preparer. The information entered in these columns reflects changes in the partner's capital account during the year, and is derived from Schedule M of Form 1065, which shows the reconciliation of the capital accounts of all partners. The ending capital account balance, Line J, column (e), rep-

resents the **inside basis** of that individual partner, which may not agree with the partner's **outside basis** as per the individual records of that partner.

Lines 1 through 25

Partners who are not involved in passive activities can take the amounts reflected in column (b) from their Schedule K-1 and enter them on the lines of their tax return as indicated in column (c). **If the passive activity rules apply,** the partner should report the amounts in column (b) as indicated in the instructions for Form 8582. All amounts reflected on Schedule K-1 for the individual partner are made without reference to any particular partner's limitation on losses or adjustments that may be required because of

- The partner's adjusted basis in the partnership interest
- The amount for which the partner is at risk as determined under I.R.C. §465
- The passive activity limitations of I.R.C. §469

		(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Ordinary dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f)
	e	Net long-term capital gain (loss):			
		(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
		(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f	Other portfolio income (loss) *(attach schedule)*	4f		Enter on applicable line of your return.
	5	Guaranteed payments to partner	5		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
	6	Net section 1231 gain (loss) (other than due to casualty or theft)	6		
	7	Other income (loss) *(attach schedule)*	7		Enter on applicable line of your return.

Distributive Share Items—Income (Loss)

Line 1–Ordinary income (loss) from trade or business activities. This represents the individual partner's share of the ordinary income (loss) from the trade or business activities of the partnership.

1. If the partner materially participated (as defined by I.R.C. §469), the income (loss) is reported on Schedule E (Form 1040), part II, column (i) or (k).
2. If the partner did not materially participate, the amounts are reported as follows:
   a. If income is shown on line 1, report the income on Schedule E, part II, column (h). If there is a passive activity from this partnership, also report the line 1 income following the instructions for Form 8582.
   b. If a loss is reported on line 1, report the loss as instructed on Form 8582.

Line 2–Net income (loss) from rental real estate activities. The amount entered on this line is from a passive activity, but may qualify for the $25,000 rental real estate deduction.

1. If a loss is reported on line 2, and **all** the following conditions are met, the loss is reported on Schedule E (Form 1040), part II, column (g):

a. The partner actively participated in the activity.

b. There was active participation in rental real estate activities, and these were the taxpayer's only passive activities.

c. There are no unallowed losses from prior years from these activities.

d. The total losses from rental real estate activities did not exceed $25,000.

e. If the taxpayer is married filing separately, he or she did not live with the spouse during the year.

f. The partner does not have any current or prior year unallowed credits from any other passive activities.

g. The partner's modified AGI does not exceed $100,000 (or $50,000 if married filing separately and living apart from the other spouse for the entire year).

h. The taxpayer is a general partner and **not** a limited partner.

i. The taxpayer (including the spouse) owns at least a 10% interest in the rental real estate property.

2. If there is a loss and not all the conditions above were met, the partner's loss follows the reporting instructions for Form 8582.
3. If income is reported on line 2, it is entered on Schedule E, Part II, column (h). If the partner has any loss from this partnership or any other source, the line 2 income should also be reported according to the instructions for Form 8582.

Line 3—Net income (loss) from other rental activities. Amounts reported on this line are generally from a passive activity.

1. If a loss, report per the instructions for Form 8582.
2. If a gain, report the income on Schedule E (Form 1040), part II, column (h).

Line 4—Portfolio income (loss). This includes taxable interest income, dividends, annuities, and royalty, income not derived in the ordinary course of a trade or business. Also included are gains or losses on the sale of property held for investment or property that produces portfolio income.

Line 5—Guaranteed payments to partners. Amounts on this line are generally not from a passive activity, and should be reported on Schedule E (Form 1040), part II, column (k). Health insurance premiums paid by the partnership for the partners are included here.

Line 6—Net §1231 gain (loss) (other than due to casualty or theft). If the amount reported on line 6 is from a rental activity or from a trade or business in which the taxpayer does not materially participate, it is passive activity income.

- If the amount on line 6 is not a passive activity amount, it is reported on Form 4797, line 2, column (g).
- If line 6 shows a gain and it is from a passive activity, the amount is reported on Form 4797, line 2, column (g).
- If line 6 shows a loss and it is from a passive activity, follow the instructions for Form 8582 to determine if any of the loss is allowable on Form 4797.

Deductions	8	Charitable contributions (see instructions) *(attach schedule)*	8		Sch. A, line 15 or 16
	9	Section 179 expense deduction	9		See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	10	Deductions related to portfolio income *(attach schedule)*	10		
	11	Other deductions *(attach schedule)*	11		

Distributive Share Items—Deductions

Line 8–Charitable contributions. This represents the partner's share of partnership contributions. A list of those contributions subject to the 50%, 30%, and 20% of modified adjusted gross income limitation should be provided with the Schedule K-1, but often is not attached. Form 8283 is required for any partnership donations of property that exceed $5,000.

Line 9–Section 179 expense deduction. The amount shown on this line is added to any other §179 expense amounts the partner might have on Form 4562. If any part of the partner's §179 amount is from passive activities, the instructions for Form 8582 must be followed. If the §179 amount is not from a passive activity, then such amount is recorded on Schedule E (Form 1040), part II, column (j).

> **Practitioner Note.** A partner can claim $19,000 of §179 expense in 1999 from all sources. If the partner's share of §179 expense causes the partner's total to exceed the limit, the excess cannot be carried forward.

Line 10–Deductions related to portfolio income. Amounts shown here are clearly and directly related to portfolio income, and are generally entered on Schedule A (Form 1040), line 21.

Line 11–Other deductions. This represents a catch-all for flow through deductions that are not included elsewhere. Some examples include

- Payments on behalf of a partner to an IRA, SEP, or Keogh plan
- Any penalty for early withdrawal of savings
- Disabled access expenditures

Credits	12a	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	a(1)		Form 8586, line 5
		(2) Other than on line 12a(1) for property placed in service before 1990	a(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	a(3)		
		(4) Other than on line 12a(3) for property placed in service after 1989	a(4)		
	b	Qualified rehabilitation expenditures related to rental real estate activities	12b		
	c	Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities	12c		See page 8 of Partner's Instructions for Schedule K-1 (Form 1065).
	d	Credits related to other rental activities	12d		
	13	Other credits	13		

Distributive Share Items—Credits

Line 12a–Low income housing credit. There are presently four unique sources of this credit that need to be separately stated when entering on Form 8586 (Form 1040).

Line 12b–Qualified rehabilitation expenditures related to rental real estate activities. The partner's Schedule K-1 should have a separate statement detailing the expenses related to each rental real estate activity so that the correct amount is entered on the correct line of Form 3468 (Form 1040).

Line 12c–Credits related to real estate activities. This is for any credits other than low-income housing and rehabilitation credits.

Line 12d–Credits relating to other rental activities. This will report other credits available to the partner from any nonrental real estate activity.

Line 13–Other credits. These credits relate to any trade or business activity. They include

- Disabled Access Credit (Form 8826)
- Enhanced Oil Recovery Credit (Form 8830)
- Credit for FICA taxes paid on employee tips (Form 8846)
- Credit for backup withholding
- Work Opportunity Credit (Form 5884)

Investment Interest	14a	Interest expense on investment debts	14a		Form 4952, line 1
	b	(1) Investment income included on lines 4a, 4b, 4c, and 4f	b(1)		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
		(2) Investment expenses included on line 10	b(2)		

Distributive Share Items—Investment Interest

Line 14a–Interest expense on investment debts. This line includes interest paid or accrued to purchase or carry property held as an investment. It is carried to the partner's Form 4952 (Form 1040).

Lines 14b(1) and 14b(2)–Investment income and expense. Line 14b(1) will reflect the total portfolio income from line 4. Line 14b(2) includes the portion of the investment expense from line 10 (deductions related to portfolio income).

Self-employment	15a	Net earnings (loss) from self-employment	15a		Sch. SE, Section A or B
	b	Gross farming or fishing income	15b		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
	c	Gross nonfarm income	15c		

Distributive Share Items—Self-Employment Income

Line 15a–Net earnings (loss) from self-employment. This amount should be adjusted at the partner level by any §179 expense, unreimbursed partnership expenses claimed, and depletion claimed on oil and gas properties. The result is reported on line 2 of the partner's Schedule SE. If the amount is a loss, enter only the deductible portion on Schedule SE.

Line 15b–Gross farming or fishing income. Individual partners need to enter this amount on Schedule E (Form 1040), part V, line 41. This amount may also be used to compute self-employment income under the optional method on Schedule SE (Form 1040), section B, part II.

Line 15c–Gross nonfarm income. Partners can use this amount to compute net earnings from self-employment under the nonfarm optional method in section B, part II, of Schedule SE (Form 1040).

Adjustments and Tax Preference Items	16a	Depreciation adjustment on property placed in service after 1986	16a		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065) and Instructions for Form 6251.
	b	Adjusted gain or loss	16b		
	c	Depletion (other than oil and gas)	16c		
	d	(1) Gross income from oil, gas, and geothermal properties	d(1)		
		(2) Deductions allocable to oil, gas, and geothermal properties	d(2)		
	e	Other adjustments and tax preference items *(attach schedule)*	16e		

Distributive Share Items—Tax Preferences

Line 16a–Depreciation adjustment. This represents the difference between depreciation claimed on property placed in service after 1986 for regular tax purposes and the depreciation allowed under the alternative minimum tax rules.

Line 16b–Adjusted gain or loss. This preference item results from the sale of tangible personal property that was depreciated at an accelerated rate. Gain is recomputed using the AMT basis and the difference between the recomputed gain, and the gain reported for the regular tax is a partner preference item.

Line 16c–Depletion (other than oil and gas). This reports the difference in the percentage depletion for regular taxes and the percentage depletion for the AMT.

Lines 16d(1), 16d(2), and 16(e). For oil and gas properties, the individual partner should have a supporting schedule showing how these preference items were determined. All preference items are carried to Form 6251 (Form 1040).

Foreign Taxes				
17a	Type of income ▶			Form 1116, check boxes
b	Name of foreign country or possession ▶			Form 1116, Part I
c	Total gross income from sources outside the United States *(attach schedule)*	**17c**		Form 1116, Part I
d	Total applicable deductions and losses *(attach schedule)*	**17d**		Form 1116, Part I
e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	**17e**		Form 1116, Part II
f	Reduction in taxes available for credit *(attach schedule)*	**17f**		Form 1116, Part III
g	Other foreign tax information *(attach schedule)*	**17g**		See Instructions for Form 1116.

Distributive Share Items—Foreign Tax

Lines 17a–17g–Foreign taxes. The information on these lines is used to compute the partner's foreign tax credit. Individual partners use Form 1116 for that computation.

Other				
18	Section 59(e)(2) expenditures: **a** Type ▶			See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
b	Amount	**18b**		See page 9 of Partner's Instructions for Schedule K-1 (Form 1065).
19	Tax-exempt interest income	**19**		Form 1040, line 8b
20	Other tax-exempt income	**20**		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
21	Nondeductible expenses	**21**		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
22	Distributions of money (cash and marketable securities)	**22**		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
23	Distributions of property other than money	**23**		See pages 9 and 10 of Partner's Instructions for Schedule K-1 (Form 1065).
24	Recapture of low-income housing credit:			
a	From section 42(j)(5) partnerships	**24a**		Form 8611, line 8
b	Other than on line 24a	**24b**		Form 8611, line 8

Distributive Share Items—Other

Lines 18a–18b–Section 59(e) expenditures. This is an election at the partnership level to allow the individual partner to deduct certain costs over a period of years. These costs include intangible drilling costs, circulation expenditures, and research and development costs.

Line 19–Tax-exempt interest. This is any tax-exempt interest that is **not** part of the portfolio income. The partner reports this on Line 8b of Form 1040.

Line 20–Other tax-exempt income. An example is life insurance proceeds.

Line 21–Nondeductible expenses. This includes penalties and any other expenses not deducted or reflected elsewhere on the Schedule K-1.

Line 22–Distributions of money (cash and marketable securities). If any part of the distribution represents marketable securities, the partner's Schedule K-1 needs to have an attached statement detailing both fair market value and adjusted basis of those securities.

Line 23–Distributions of property other than money. The valuation to the partner is the partnership adjusted basis of the property immediately before the distribution.

Lines 24a–24b–Recapture of low-income housing credit. The individual partner carries his or her recapture amount to Form 8611 (Form 1040).

Supplemental Information

25 Supplemental information required to be reported separately to each partner *(attach additional schedules if more space is needed):*

Line 25–Supplemental information. This is a narrative section of the partner's Schedule K-1 to support any detail needed for line items or to give the partner any other detailed information necessary to file his or her individual income tax return.

PARTNER PROBLEM 1

Your client, Bob Simpkins, brings a Schedule K-1 to his tax appointment with you (see next page). Bob explains to you that he and his girlfriend watched late-night infomercials to learn how to buy real estate without putting any money down. This is exactly what Bob and his girlfriend did in January 1999; they acquired an apartment building at a foreclosure sale and financed the full purchase with a personal guarantee of the mortgage at the bank. Bob claims he is entitled to his full loss because the man on TV said this was all right to do just before he was sent off to prison. Bob's adjusted gross income for 1999 is $43,000 before considering the flow-through items from this partnership.

Question 1. *As Bob's tax return preparer, are you going to allow this deduction?*

Answer. The answer is yes–Bob is correct. The key point here is that Bob is personally responsible for $100,000 of the debt. Bob's basis is $100,000, and he can absorb the full rental loss. He will be able to deduct the $11,000 on Schedule E (no Form 8582 is needed) and report the $500 interest income on Schedule B.

Question 2. *What if Bob also took out a $5,000 cash distribution, which would mean his capital account would erode to ($15,500). Can he still deduct his loss, and does he have to pay tax on the $5,000?*

Answer: Yes, he can fully deduct the loss, and the $5,000 is not taxable to him.

SCHEDULE K-1 (Form 1065) Department of the Treasury Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning , 1999, and ending ,

OMB No. 1545-0099 **1999**

Partner's identifying number ▶ *156-99-0007* | **Partnership's identifying number ▶** *13 1470009*

Partner's name, address, and ZIP code

Robert Simpkins
38 Longacre Drive
Jefferson City, MO 65022

Partnership's name, address, and ZIP code

Simpkins & Braun
38 Longacre Drive
Jefferson City, MO 65022

A This partner is a ☒ general partner ☐ limited partner ☐ limited liability company member
B What type of entity is this partner? ▶ *Individual*
C Is this partner a ☒ domestic or a ☐ foreign partner?
D Enter partner's percentage of: (i) Before change or termination / (ii) End of year
Profit sharing *50* % *50* %
Loss sharing *50* % *50* %
Ownership of capital *50* % *50* %
E IRS Center where partnership filed return: *Kansas City*

F Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $
Other $ *100,000*
G Tax shelter registration number ▶
H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐
I Check applicable boxes: **(1)** ☐ Final K-1 **(2)** ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
0	*0*	*(10,500)*	(*0*)	*(10,500)*

(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
1 Ordinary income (loss) from trade or business activities	1		See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
2 Net income (loss) from rental real estate activities	2	*(11,000)*	
3 Net income (loss) from other rental activities	3		
4 Portfolio income (loss):			
a Interest	4a	*500*	Sch. B, Part I, line 1

PARTNER PROBLEM 2

Your new client, Mr. Gates Dell, comes into your office on the afternoon of April 14, 2000, with his tax information and Schedule K-1 (Form 1065) from his company, Everybody Get Rich.Com.

SCHEDULE K-1 (Form 1065) Department of the Treasury Internal Revenue Service

Partner's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning , 1999, and ending ,

OMB No. 1545-0099 **1999**

Partner's identifying number ▶ *751-99-7600* | **Partnership's identifying number ▶** *36 7200642*

Partner's name, address, and ZIP code

Gates Dell
712 Windsor
Palm Beach, FL 11052

Partnership's name, address, and ZIP code

Everybody Get Rich.Com
P O Box 219
Chicago, IL 60606

A This partner is a ☒ general partner ☐ limited partner ☐ limited liability company member
B What type of entity is this partner? ▶ *Individual*
C Is this partner a ☒ domestic or a ☐ foreign partner?
D Enter partner's percentage of: (i) Before change or termination / (ii) End of year
Profit sharing *50* % *50* %
Loss sharing *50* % *50* %
Ownership of capital *50* % *50* %
E IRS Center where partnership filed return: *Kansas City*

F Partner's share of liabilities (see instructions):
Nonrecourse $
Qualified nonrecourse financing $
Other $
G Tax shelter registration number ▶
H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) ☐
I Check applicable boxes: **(1)** ☐ Final K-1 **(2)** ☐ Amended K-1

J Analysis of partner's capital account:

(a) Capital account at beginning of year	(b) Capital contributed during year	(c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2	(d) Withdrawals and distributions	(e) Capital account at end of year (combine columns (a) through (d))
0	*10,000*	*145,000*	(*130,000*)	*25,000*

	(a) Distributive share item		(b) Amount	(c) 1040 filers enter the amount in column (b) on:
1	Ordinary income (loss) from trade or business activities . . .	1	*145,000*	See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).
2	Net income (loss) from rental real estate activities	2		
3	Net income (loss) from other rental activities	3		

Mr. Dell provides only page 1 of his Schedule K-1 (see Exhibit 3). As the tax preparer, you press him on the nature of his business, and learn that it is an Internet consulting business in which Mr. Dell is an active participant. His partner, Mr. Corby Compaq, had the partnership return prepared elsewhere, and Mr. Compaq is out of the country until May 2000. You point out to Mr. Dell that the $145,000 not only represents taxable income, but is also income subject to self-employment taxes. At this point, Mr. Dell wants to debate the issue because he says self-employment income is not disclosed on his Schedule K-1. Mr. Dell did not bring along the second page, which should have reflected net earnings from self-employment income on line 15a.

Question. *How do you resolve this issue?*

Answer. Clearly, the income earned by the client from his active participation in a trade or business is subject to self-employment tax. The fact that the client does not have a page 2 of the partnership Schedule K-1 (or even if the entry on line 15a were omitted) does not relieve Mr. Dell of his self-employment tax exposure. You should use your professional skills to convince Mr. Dell to pay the self-employment tax. He could also file an extension (Form 4868) and pay all tax, including self-employment tax, with the extension until the matter can be resolved with his partner and the preparer of the Form 1065.

C. S SHAREHOLDER SCHEDULES K-1

Schedules K-1 provided to shareholders in S corporations have generally the same line items of income, deductions, and credits as on the partnership Schedules K-1, with certain notable exceptions. The shareholder's share of S corporation income is not self-employment income, and it is not subject to self-employment tax whether or not such income is distributed to the shareholder. A complete copy of a Schedule K-1 is on page 50.

The shareholder is responsible for maintaining the basis in his or her stock in the S corporation. Schedule K-1 (Form 1120S) does not provide any reconciliation of basis, unlike Schedule K-1 (Form 1065). It thus becomes necessary for the preparer to track basis in the client's stock by using a worksheet format such as the one at the end of this chapter. Not only does the shareholder have to track his or her initial investment, but the shareholder also has to add later investments and profits, and subtract losses and distributions. Once this basis determination is made, the shareholder can also add debt directly owed to the shareholder by the corporation. This does **not** include any bank debt, outside debt, and any other debt even if the shareholder personally guarantees such obligations (a major difference from partnerships).

Shareholders can deduct their share of losses in an S corporation to the extent of their basis, subject to the passive activity rules of I.R.C. §469. Any loss not allowed for the tax year because of basis limitations is available for indefinite carryover, limited to the basis of the shareholder's stock and debt, in each subsequent tax year.

SCHEDULE K-1 (Form 1120S)

Department of the Treasury
Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning , 1999, and ending ,

OMB No. 1545-0130

1999

Shareholder's identifying number ▶ | **Corporation's identifying number ▶**

Shareholder's name, address, and ZIP code | Corporation's name, address, and ZIP code

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . . . . ▶ .... %
B Internal Revenue Service Center where corporation filed its return ▶ ....
C Tax shelter registration number (see instructions for Schedule K-1) . . . . ▶ ....
D Check applicable boxes: **(1)** ☐ Final K-1 **(2)** ☐ Amended K-1

		(a) Pro rata share items		**(b)** Amount	**(c)** Form 1040 filers enter the amount in column (b) on:
Income (Loss)	1	Ordinary income (loss) from trade or business activities	1		See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	2	Net income (loss) from rental real estate activities	2		
	3	Net income (loss) from other rental activities	3		
	4	Portfolio income (loss):			
	a	Interest	4a		Sch. B, Part I, line 1
	b	Ordinary dividends	4b		Sch. B, Part II, line 5
	c	Royalties	4c		Sch. E, Part I, line 4
	d	Net short-term capital gain (loss)	4d		Sch. D, line 5, col. (f)
	e	Net long-term capital gain (loss):			
		(1) 28% rate gain (loss)	e(1)		Sch. D, line 12, col. (g)
		(2) Total for year	e(2)		Sch. D, line 12, col. (f)
	f	Other portfolio income (loss) *(attach schedule)*	4f		(Enter on applicable line of your return.)
	5	Net section 1231 gain (loss) (other than due to casualty or theft)	5		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	6	Other income (loss) *(attach schedule)*	6		(Enter on applicable line of your return.)
Deductions	7	Charitable contributions *(attach schedule)*	7		Sch. A, line 15 or 16
	8	Section 179 expense deduction	8		See page 6 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	9	Deductions related to portfolio income (loss) *(attach schedule)*	9		
	10	Other deductions *(attach schedule)*	10		
Investment Interest	11a	Interest expense on investment debts	11a		Form 4952, line 1
	b	**(1)** Investment income included on lines 4a, 4b, 4c, and 4f above	b(1)		See Shareholder's Instructions for Schedule K-1 (Form 1120S).
		(2) Investment expenses included on line 9 above	b(2)		
Credits	12a	Credit for alcohol used as fuel	12a		Form 6478, line 10
	b	Low-income housing credit:			
		(1) From section 42(j)(5) partnerships for property placed in service before 1990	b(1)		Form 8586, line 5
		(2) Other than on line 12b(1) for property placed in service before 1990	b(2)		
		(3) From section 42(j)(5) partnerships for property placed in service after 1989	b(3)		
		(4) Other than on line 12b(3) for property placed in service after 1989	b(4)		
	c	Qualified rehabilitation expenditures related to rental real estate activities	12c		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	d	Credits (other than credits shown on lines 12b and 12c) related to rental real estate activities	12d		
	e	Credits related to other rental activities	12e		
	13	Other credits	13		

For Paperwork Reduction Act Notice, see the Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 1999**

		(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
Adjustments and Tax Preference Items	14a	Depreciation adjustment on property placed in service after 1986	14a		See page 7 of the Shareholder's Instructions for Schedule K-1 (Form 1120S) and Instructions for Form 6251
	b	Adjusted gain or loss	14b		
	c	Depletion (other than oil and gas)	14c		
	d	(1) Gross income from oil, gas, or geothermal properties	d(1)		
		(2) Deductions allocable to oil, gas, or geothermal properties	d(2)		
	e	Other adjustments and tax preference items *(attach schedule)*	14e		
Foreign Taxes	15a	Type of income ▶			Form 1116, Check boxes
	b	Name of foreign country or U.S. possession ▶			
	c	Total gross income from sources outside the United States *(attach schedule)*	15c		Form 1116, Part I
	d	Total applicable deductions and losses *(attach schedule)*	15d		
	e	Total foreign taxes (check one): ▶ ☐ Paid ☐ Accrued	15e		Form 1116, Part II
	f	Reduction in taxes available for credit *(attach schedule)*	15f		Form 1116, Part III
	g	Other foreign tax information *(attach schedule)*	15g		See Instructions for Form 1116
Other	16	Section 59(e)(2) expenditures: **a** Type ▶			See Shareholder's Instructions for Schedule K-1 (Form 1120S).
	b	Amount	16b		
	17	Tax-exempt interest income	17		Form 1040, line 8b
	18	Other tax-exempt income	18		See pages 7 and 8 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
	19	Nondeductible expenses	19		
	20	Property distributions (including cash) other than dividend distributions reported to you on Form 1099-DIV	20		
	21	Amount of loan repayments for "Loans From Shareholders"	21		
	22	Recapture of low-income housing credit:			
	a	From section 42(j)(5) partnerships	22a		Form 8611, line 8
	b	Other than on line 22a	22b		

Supplemental Information

23 Supplemental information required to be reported separately to each shareholder *(attach additional schedules if more space is needed)*:

S SHAREHOLDER PROBLEM

Your client, Mr. Don Pitchford, is a 40% shareholder and is actively involved in an S corporation known as the Grace Lee Airlines & Storm Door Company. You do not prepare this corporate tax return. He provides you with a copy of his 1999 Schedule K-1 (Form 1120S), which reports a $3,500 loss.

SCHEDULE K-1 (Form 1120S)

Department of the Treasury Internal Revenue Service

Shareholder's Share of Income, Credits, Deductions, etc.

▶ See separate instructions.

For calendar year 1999 or tax year beginning , 1999, and ending ,

OMB No. 1545-0130

1999

Shareholder's identifying number ▶ *862-99-4646*	Corporation's identifying number ▶ *49 141477*
Shareholder's name, address, and ZIP code *Donald Pitchford* *1818 Western Way* *Madison, WI 59500*	Corporation's name, address, and ZIP code *Grace Lee Airlines & Storm Door Company* *#10 Valley View Industrial Park* *Madison, WI 59502*

A Shareholder's percentage of stock ownership for tax year (see instructions for Schedule K-1) . . . . . . ▶ *40* %
B Internal Revenue Service Center where corporation filed its return ▶ *Kansas City*
C Tax shelter registration number (see instructions for Schedule K-1) . . . . ▶
D Check applicable boxes: (1) ☐ Final K-1 (2) ☐ Amended K-1

(a) Pro rata share items		(b) Amount	(c) Form 1040 filers enter the amount in column (b) on:
1 Ordinary income (loss) from trade or business activities	1	*(3,500)*	See pages 4 and 5 of the Shareholder's Instructions for Schedule K-1 (Form 1120S).
2 Net income (loss) from rental real estate activities	2		
3 Net income (loss) from other rental activities	3		
4 Portfolio income (loss):			
a Interest	4a		Sch. B, Part I, line 1
b Ordinary dividends	4b		Sch. B, Part II, line 5

Mr. Pitchford is very pleased that his company is finally starting to turn around after years of large operating losses. He also boasts that the company obtained bank financing in 1999 that enabled the company to repay the $50,000 in loans that Mr. Pitchford had made to the company in earlier years. Mr. Pitchford also makes the statement to you that he knows these loan repayments are not taxable to him.

Question 1. *Can the taxpayer deduct his 1999 loss of $3,500?*

Question 2. *Should there be any concern regarding the loan repayment in 1999?*

Answers. Although many tax preparers would simply report the $3,500 loss from the S corporation, an experienced practitioner will go one step further to detail the shareholder history of income (loss), loans, and distributions of the company. The preparer is well aware of the fact that the IRS agent will do the same detail work if the return is selected for examination.

The company began as an S corporation in 1996. Mr. Pitchford is a 40% owner because his capital stock investment in 1996 was $5,000 (see Exhibit 7). He loaned the company $50,000 in 1997, and this loan was fully repaid in 1999. Because of his direct loans to the corporation, Mr. Pitchford has been able to deduct all losses to date. A brief financial history of the taxpayer's involvement in the company is as follows:

	1996	1997	1998	1999
Investment	5,000	0	0	0
Profit (loss)	(3,000)	(35,000)	(17,000)	(3,500)
Distributions	0	0	0	0
Loans made	0	50,000	0	0
Loans repaid	0	0	0	50,000

The best way for the preparer to track basis is to use the shareholder basis worksheet shown on the next page. From the above information, the preparer can now determine that the 1999 loss of $3,500 **cannot** be deducted in the current year, as the taxpayer has used up all available basis. Further, the

$50,000 loan repayment to Mr. Pitchford triggers a capital gain, since this was a distribution to the shareholder in excess of basis.

When a corporation repays a loan to a shareholder, the shareholder must recognize gain if the basis is less than the amount repaid. When there is income in the same year as repayment, the shareholder restores basis to the repaid loan, up to its original amount.

SCHEDULE OF SHAREHOLDER'S BASIS

Shareholder	Donald Pitchford	Soc. Sec.	# 862-99-4646
Corporation	Grace Lee Airlines & Storm Door Co	I.D.	# 49-1414177
Original Cost of Stock	$ 5,000		

Year	1996	1997	1998	1999		
Ownership Percentage	40%	40%	40%	40%		
Capital Basis						
1. Balance – Beginning of Year	5,000	2,000	0	0		
2. Additional Investments						
3. Current Year Ordinary Income						
4. Current Year Separately Stated Taxable Income						
5. Current Year Separately Stated Tax-Exempt Income						
6. Current Year Total Ordinary Loss	(3,000)	(35,000)	(17,000)	(3,500)	( )	( )
7. Current Year Separately Stated Taxable Losses	( )	( )	( )	( )	( )	( )
8. Current Year Separately Stated Deductions	( )	( )	( )	( )	( )	( )
9. Currently Year Nondeductible Expenses	( )	( )	( )	( )	( )	( )
10. Distributions (Not to Exceed Stock Basis Before Distributions)	( )	( )	( )	( )	( )	( )
11. Current Loss in Excess of Stock Basis		33,000	17,000	3,500		
12. Loss Carryover Utilized	( )	( )	( )	( )	( )	( )
13. Other						
14. Balance – End of Year (Not Less than Zero)	2,000	0	0	0		

(continues)

SCHEDULE OF SHAREHOLDER'S BASIS

(*continued*)

Balance of Loans from Shareholders

15. Balance – Beginning of Year	0	0	50,000	50,000		
16. Additions		50,000				
17. Reductions	( )	( )	( )	(50,000)	( )	( )
18. Balance – End of Year	0	50,000	50,000	0		

Basis in Loans from Shareholders

19. Balance – Beginning of Year	0	0	17,000	0		
20. Current Income – Restoration						
21. Additions to Loan		50,000				
22. Current Loss in Excess of Stock Basis (Line 11)	( )	(33,000)	(17,000)	(3,500)	( )	( )
23. Repayment of Loan (Part with Basis Only)	( )	( )	( )	( )	( )	( )
24. Currently Loss in Excess of Loan Basis				3,500		
25. Loss Carryover Utilized	( )	( )	( )	( )	( )	( )
26. Balance – End of Year		17,000	0	0		
Total Basis (Lines 14 and 26)	2,000	17,000	0	0		

Capital Gain from Loan Repayment

1. Total Loan Repayment	0	0	0	50,000		
2. Repayment Allocated to Loan with Basis (Line 23)	( )	( )	( )	( )	( )	( )
3. Capital Gain from Loan Repayment	0	0	0	50,000		

Capital Gain Distribution (Excess Distribution)

1. Total Distribution	0	0	0	50,000		
2. Amount Applied to Stock Basis (Line 10)	( )	( )	( )	( )	( )	( )
3. Capital Gain Distribution	0	0	0	50,000		

Loss Carryover

1. Unused Loss – Beginning of Year	0	0	0	0		
2. Current Unused Loss (Line 11 or Line 24)				(3,500)		
3. Prior Years' Losses Utilized in Current Year	( )	( )	( )	( )	( )	( )
4. Unused Loss – End of Year	0	0	0	(3,500)		

D. BENEFICIARY'S SCHEDULE K-1 (FORM 1041)

The Schedule K-1 (Form 1041) received by a beneficiary represents the beneficiary's share of income, expense, or credits from either a trust or a decedent's estate. This represents the income (expense) distributed or required to be distributed during the tax year. The beneficiary's Schedule K-1 uses fewer line entries than the partnership and S corporation Schedules K-1, and many Schedule K-1 (Form 1041) items are similar to Schedule K-1 (Form 1065). However, this Schedule K-1 segregates depreciation, depletion, and amortization (all noncash expenses) from both nonpassive income (line 5a) and passive income (line 6a). Also, certain deductions flowing to the beneficiary become available only on termination of the estate or trust. These deductions are reported on lines 13a–13e of the final Schedule K-1.

BENEFICIARY PROBLEM

You have been engaged to prepare the 1999 individual income tax return for John C. Lightfoot III. Along with his usual tax information, John brings a Schedule K-1 (Form 1041) for the estate of John C. Lightfoot II, who died while at a bungee-jumping meet in Australia on April 24, 1998. Your client and Bubbles (the fourth wife of John C. Lightfoot II) are the only beneficiaries of this estate. This beneficiary Schedule K-1 is shown on page 57.

Question 1. *In what year does the preparer reflect the items of income and expense on the Form 1040 for John C. Lightfoot III?*

Answer. Although the executor of this estate correctly used a 1998 Form 1041 for the estate's fiscal year estate ending March 31, 1999, all income will be reported on the 1999 individual tax return of your client. The executor can elect any month to end the first tax year of the estate within 12 months of date of death.

Question 2. *Does the amount of tax-exempt interest reflected in line 14b reduce the total amount of interest from line 1?*

Answer. Tax-exempt interest is separately stated on line 14b and carried forward to the individual's income tax return (Form 1040, line 8b). This tax-exempt interest is **not** a part of the total taxable interest in line 1.

Practitioner Note. Trust administrators and preparers of Schedules K-1 for beneficiaries will often detail the portion of U.S. Treasury interest included in line 1. This is not to be duplicated on Form 1040, but is helpful for those clients that can exclude Treasury interest in **arriving at taxable income for certain state income tax returns.**

SCHEDULE K-1 (Form 1041)

Department of the Treasury
Internal Revenue Service

Beneficiary's Share of Income, Deductions, Credits, etc.

for the calendar year 1999, or fiscal year
beginning *4-24* **, 1999, ending** *3-31* **,** *99*
► Complete a separate Schedule K-1 for each beneficiary.

OMB No. 1545-0092

1999

☐ Amended K-1
☐ Final K-1

Name of trust or decedent's estate
Estate of John C. Lightfoot Sr

Beneficiary's identifying number ► *455-81-3487*

Estate's or trust's EIN ► *37 1207055*

Beneficiary's name, address, and ZIP code

John C. Lightfoot III
4876 Clearpool Drive
Pillars, IL 62886

Fiduciary's name, address, and ZIP code

Estate of John C. Lightfoot, Sr
% Most Trusted Bank, Executor
P O Box 325
Roachtown, IL 62884

	(a) Allocable share item		(b) Amount	(c) Calendar year 1999 Form 1040 filers enter the amounts in column (b) on:
1	Interest	1	*14,348*	Schedule B, Part I, line 1
2	Ordinary dividends	2	*32,051*	Schedule B, Part II, line 5
3	Net short-term capital gain	3		Schedule D, line 5
4	Net long-term capital gain: **a** 28% rate gain	4a		Schedule D, line 12, column (g)
b	Unrecaptured section 1250 gain	4b		Line 11 of the worksheet for Schedule D, line 25
c	Total for year	4c		Schedule D, line 12, column (f)
5a	Annuities, royalties, and other nonpassive income before directly apportioned deductions	5a		Schedule E, Part III, column (f)
b	Depreciation	5b		Include on the applicable line of the appropriate tax form
c	Depletion	5c		
d	Amortization	5d		
6a	Trade or business, rental real estate, and other rental income before directly apportioned deductions (see instructions)	6a		Schedule E, Part III
b	Depreciation	6b		Include on the applicable line of the appropriate tax form
c	Depletion	6c		
d	Amortization	6d		
7	Income for minimum tax purposes	7		
8	Income for regular tax purposes (add lines 1, 2, 3, 4c, 5a, and 6a)	8		
9	Adjustment for minimum tax purposes (subtract line 8 from line 7)	9		Form 6251, line 12
10	Estate tax deduction (including certain generation-skipping transfer taxes)	10		Schedule A, line 27
11	Foreign taxes	11		Form 1116 or Schedule A (Form 1040), line 8
12	Adjustments and tax preference items (itemize):			
a	Accelerated depreciation	12a		Include on the applicable line of Form 6251
b	Depletion	12b		
c	Amortization	12c		
d	Exclusion items	12d		2000 Form 8801
13	Deductions in the final year of trust or decedent's estate:			
a	Excess deductions on termination (see instructions)	13a		Schedule A, line 22
b	Short-term capital loss carryover	13b	( )	Schedule D, line 5
c	Long-term capital loss carryover	13c	( )	Schedule D, line 12, columns (f) and (g)
d	Net operating loss (NOL) carryover for regular tax purposes	13d	( )	Form 1040, line 21
e	NOL carryover for minimum tax purposes	13e		See the instructions for Form 6251, line 20
f		13f		Include on the applicable line of the appropriate tax form
g		13g		
14	Other (itemize):			
a	Payments of estimated taxes credited to you	14a		Form 1040, line 58
b	Tax-exempt interest	14b	*19,775*	Form 1040, line 8b
c		14c		Include on the applicable line of the appropriate tax form
d		14d		
e		14e		
f		14f		
g		14g		
h		14h		

SCHEDULE OF SHAREHOLDER'S BASIS

Shareholder ______________________ __________

Corporation ______________________ __________

Original Cost of Stock ______________________

.

Year						
Ownership Percentage						

Capital Basis

1. Balance – Beginning of Year						
2. Additional Investments						
3. Current Year Ordinary Income						
4. Current Year Separately Stated Taxable Income						
5. Current Year Separately Stated Tax-Exempt Income						
6. Current Year Total Ordinary Loss	( )	( )	( )	( )	( )	( )
7. Current Year Separately Stated Taxable Losses	( )	( )	( )	( )	( )	( )
8. Current Year Separately Stated Deductions	( )	( )	( )	( )	( )	( )
9. Currently Year Nondeductible Expenses	( )	( )	( )	( )	( )	( )
10. Distributions (Not to Exceed Stock Basis Before Distributions)	( )	( )	( )	( )	( )	( )
11. Current Loss in Excess of Stock Basis						
12. Loss Carryover Utilized	( )	( )	( )	( )	( )	( )
13. Other						
14. Balance – End of Year (Not Less than Zero)						

Balance of Loans from Shareholders						
15. Balance – Beginning of Year						
16. Additions						
17. Reductions	( )	( )	( )	( )	( )	( )
18. Balance – End of Year						
Basis in Loans from Shareholders						
19. Balance – Beginning of Year						
20. Current Income – Restoration						
21. Additions to Loan						
22. Current Loss in Excess of Stock Basis (Line 11)	( )	( )	( )	( )	( )	( )
23. Repayment of Loan (Part with Basis Only)	( )	( )	( )	( )	( )	( )
24. Currently Loss in Excess of Loan Basis						
25. Loss Carryover Utilized	( )	( )	( )	( )	( )	( )
26. Balance – End of Year						
Total Basis (Lines 14 and 26)						
Capital Gain from Loan Repayment						
1. Total Loan Repayment						
2. Repayment Allocated to Loan with Basis (Line 23)	( )	( )	( )	( )	( )	( )
3. Capital Gain from Loan Repayment						

(*continues*)