Chapter 5: Schedule K-1 Issues

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

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In 2004, the IRS began revising the Schedules K-1 for the various pass-through entities. The revision came as a result of the decision to match Schedules K-1 issued by the entity with the tax return of the recipient. The new format makes the matching process easier. The revised format was first introduced on partnership and S corporation returns. In 2005, the IRS released the revised Schedule K-1 for Form 1041.

The new design standardizes the look of the Schedule K-1 into a box format similar to other information returns and retains information included on the old Schedule K-1. One major change is the incorporation of a supplemental information box. The supplemental information box is not very large, so if more space is needed, additional pages can be attached.

PROPER REPORTING

The IRS provided important information in News Release 2007-42 regarding proper reporting on the Schedule K-1. This news release explains how Schedule K-1 information is properly reported by the flow-through entity to the recipient, and then properly reported on the recipient's return. The IRS suggests the following:

- **For flow-through entities issuing Schedules K-1.** Ensure entity information on Schedule K-1 properly identifies the taxpayer (or other entity) responsible for reporting the Schedule K-1 income.
- **For Schedule K-1 recipients.** Avoid netting or combining income against losses or expenses not reported on Form 8582, *Passive Activity Loss Limitations.* Ordinary business income should be reported separately from related deductions, such as unreimbursed partnership expenses, or the IRC §179 expense deduction.

  For example, unreimbursed partnership expenses from nonpassive activities are entered on a separate line on Schedule E, line 28, column **h**, and labeled "UPE" in column **a** of the same line. These expenses are not combined or netted against any other amounts from the partnership.

To reduce errors, the IRS also encourages electronic filing of Schedules K-1.

Simply transferring the information from the K-1 to the correct line on Form 1040 is not enough to ensure that the information is reported accurately. Tax preparers must know their clients and determine their involvement in the entity that issued the Schedule K-1. While a loss is reported on the Schedule K-1, it may not be deductible on Form 1040. Three factors must be determined prior to transferring the information:

1. Does the taxpayer have basis in the activity?
2. Is the taxpayer considered at-risk for the pass-through losses?
3. Is this a passive investment for the taxpayer?

BASIS

It is essential to understand the concept of basis when working with Schedule K-1. Determining to what extent a loss is allowed in a given year depends on basis. It is also important to understand the differences between partnership and S corporation basis.

Basis in a partnership or S corporation is more than the amount the taxpayer invested in the entity. It is affected by loans and other factors discussed below.

IMPACT OF PARTNER/SHAREHOLDER AND OUTSIDE LOANS

Loan types are important for calculating the basis in partnerships, and the Schedule K-1 gives a hint to this fact. Item M on the partnership Schedule K-1 supplies the ending loan balance of the partner's share of different types of loans incurred by the partnership.

There are two types of loans; **recourse** and **nonrecourse**. A **recourse** loan is one in which the creditor can look to the investor if the entity defaults on payment. For a **general partnership,** the lender has **recourse against all partners,** not only for their share of the loan, but for the entire amount. In a **limited partnership,** the lender only has **recourse against limited partners** who have personally guaranteed the loan and against general partners. S corporation shareholders are treated the same as a limited partnership for recourse loan purposes.

While they are rare, nonrecourse loans are occasionally made. For **nonrecourse loans,** the lender only has **recourse against the entity** and not the investors.[1] Another type of nonrecourse loan is called **qualified nonrecourse real property indebtedness**. For this type of loan, the lender only has recourse against the entity; however, a partner can use the loan to increase his basis.

The S corporation does not disclose loans made by the S corporation, because they generally do not affect basis. However, shareholder loans made directly to the S corporation affect basis.

Investors have both inside and outside basis. These amounts are normally the same unless the investor acquired his interest in the entity from someone other than the entity. In addition to inside and outside basis, a partner also has a capital account amount.

A further discussion of entity basis requires specifying entity type.

Partnership Basis Rules

A partner's **beginning basis** in the partnership is equal to the sum of:

- The adjusted bases of contributed property, **plus**
- Cash contributed, **minus**
- Loans contributed,[2] **plus**
- Loans assumed.

Basis is adjusted for gains and losses incurred by the entity and additional contributions or withdrawals made by the partner. Basis is increased by the share of the loans for which a partner is responsible. The inside basis of a partner may be the capital account shown on the K-1, plus his share of the partnership loans.

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1. Treas. Reg. §1.752-1(a)(2)
2. IRC §722

Example 1. Kyle and Lonnie are forming an equal 50-50 partnership. Kyle contributes assets having an adjusted basis at the time of contribution of $100,000. He also contributes $20,000 of cash. In addition, Kyle contributes a mortgage on one of the assets of $40,000. Kyle's beginning partnership basis is $100,000 ($100,000 + $20,000 – $40,000 + $20,000). Kyle's basis was reduced by the $40,000 mortgage he contributed, but it was increased by $20,000, his share of the mortgage once it was inside the partnership.

Kyle's adjusted basis of assets contributed	$100,000
Cash contributed	20,000
Mortgage contributed	(40,000)
Partnership debt assumed	20,000
Initial basis	$100,000

Example 2. Continuing with **Example 1,** Lonnie contributes assets with a basis of $100,000 and a mortgage payable of $20,000. Lonnie's basis in the partnership is $110,000 ($100,000 – 20,000 + $10,000 + $20,000). Lonnie increases his basis by the $20,000 of mortgage contributed by Kyle. In addition, Kyle has a new basis of $110,000 ($100,000 + $10,000) because he increases his basis by his 50% share of the $20,000 mortgage contributed by Lonnie.

Lonnie's adjusted basis of assets contributed	$100,000
Cash contributed	0
Mortgage contributed	(20,000)
Partnership debt assumed (Lonnie)	10,000
Partnership debt assumed (Kyle)	20,000
Beginning basis	$110,000

Kyle's basis from Example 1	$100,000
Partnership debt assumed (Lonnie)	10,000
Beginning basis	$110,000

In **Example 1** and **Example 2,** Lonnie and Kyle's inside and outside basis are the same. However, this is not always the case. When an investor becomes a partner by purchasing a partnership interest from an existing partner, he pays FMV for the interest. This can be substantially different than its basis.

Example 3. Lonnie sells one-half of his partnership interest in the Kyle–Lonnie Partnership from **Example 2** to Susan for $200,000. The purchase price of $200,000 is Susan's outside basis. Her inside basis is $55,000, one-half of Lonnie's basis.

A **general partner** increases his basis by his share of recourse, nonrecourse, and qualified real property recourse indebtedness. A **limited partner** only increases basis by his share of qualified nonrecourse indebtedness.[3]

Each partners' **capital account** is shown on his respective K-1. The beginning capital account is equal to the beginning inside basis but is not increased for any share of the partnership liabilities. Although the capital account may be a negative amount, neither the inside nor outside basis can fall below zero. Any distribution from the partnership in excess of the partner's basis must be recognized as income to the partner.

The **inside basis** includes the basis of the partnership assets. While the **inside basis is tracked by the partnership,** the **outside basis must be tracked by the partner** or his tax preparer. When a partner sells his partnership interest, gain or loss is determined by the difference between the selling price and the outside basis.

The partner's **at-risk amount** is the same as the basis, except the **debts included for at-risk purposes include only recourse and qualified nonrecourse debts.** The at-risk amount limits a taxpayer's losses. Unfortunately, the at-risk amount is commonly referred to as the taxpayer's basis for simplification purposes.

3. *J.V. Elrod v. Comm'r,* 87 TC 1046 (1986)

The **ordering rule** for increases and decreases in basis follows. Basis is affected as follows:

1. **Increased by additional contributions to capital.** For this purpose, an increase in the partner's share of debts is an addition to basis.
2. **Increased by any income items passed through** on the Schedule K-1, whether taxable or nontaxable. This includes ordinary income, interest income, and net rental income.
3. **Decreased by nondeductible expenses,** such as the 50% meals and entertainment expenses.
4. **Decreased by deductible losses and expenses,** such as charitable contributions and IRC §179 expenses.
5. **Decreased by distributions.** For this purpose a decrease in the partner's share of debts is a distribution.

Decreases other than distributions can never cause a partner's basis to go below zero. Any amount of losses or deductions which would create a negative amount is subject to the basis rules and is carried to the following year.

Distributions can cause a partner's basis to go below zero. However, any amount below zero must be reported by the partner as income. These are commonly called "distributions in excess of basis" on Schedule D. They are reported as long- or short-term capital gains, depending on the holding period of the partnership interest.

Temp. Treas. Reg. §1.469-2T(d)(6) deals with the allocation of losses and deductions if the total is not allowed due to basis limitations. Although this regulation is found in the passive portion[4] of the regulations, it addresses allocations for IRC §704 (partnerships) and IRC §1366 (S corporations). The losses and deductions must be prorated by comparing the individual amounts to the total of the amounts.

Example 4. If a disallowed loss is $10,000, and the ordinary loss that is passed through represents 90% of the overall losses and deductions, then $9,000 (90%) of the disallowed loss belongs to the ordinary loss.

S Corporation

An S corporation shareholder does not have a basis adjustment due to corporation loans unless he directly loans the S corporation money. Even a personal guarantee does not increase basis.

Loans affect basis differently for S corporations as compared to partnerships. For S corporations, two types of basis are used to calculate total basis. One is **stock basis** and the other is **loan basis.**

The **beginning basis** of S corporation stock is the cash and adjusted basis of property contributed to the corporation. If the shareholder received the stock by inheritance, gift, or other means, the beginning basis is determined accordingly.

Treas. Reg. §1.1367-1(e) provides specific ordering rules for the adjustment of basis each year. Using the **ordering rule**, stock basis is:

1. **Increased by additional contributions to capital;**
2. **Increased by income items passed through** on the Schedule K-1, whether taxable or nontaxable (including ordinary income, interest income, and net rental income);

> **Note.** Beginning October 2001, nontaxable cancellation of indebtedness does not increase a shareholder's basis.

3. **Decreased by distributions;**
4. **Decreased by nondeductible expenses,** such as the 50% meals and entertainment expenses; and
5. **Decreased by deductible losses and expenses,** such as charitable contributions and IRC §179 expense.

4. IRC §469

Decreases other than distributions can never cause stock basis to go below zero. Any amount of losses or deductions in excess of basis is subject to the basis rules and is suspended until the following year. Form 6198, *At-Risk Limitation,* must be included with the tax return when there are losses larger than the taxpayer's at-risk amount.

Distributions can cause stock basis to go below zero. However, any amount below zero must be reported by the shareholder as income. These are commonly called "distributions in excess of basis" on Schedule D. They are reported as long- or short-term capital gains, depending on the holding period of the stock.

Example 5. In Year 1, Brandon contributed $5,000 to BAB Corporation in exchange for 100% of the S corporation's stock. The Schedule K-1 for Year 1 showed a nonseparately stated ordinary loss of $7,000 and nondeductible expenses of $500.

Brandon's basis is calculated as follows:

Beginning basis	$5,000
Nondeductible expenses	(500)
Subtotal	$4,500
Deductible losses	(4,500)
Ending basis	$ 0

The remaining deductible loss of $2,500 ($7,000 – $4,500) is carried over to Year 2.

In Year 2, Brandon made an additional contribution of $1,000 to BAB Corporation. The Schedule K-1 for Year 2 shows nonseparately stated ordinary income of $1,250 and nondeductible expenses of $500.

Brandon's basis is calculated as follows:

Beginning basis (from end of Year 1)	$ 0
Additions to capital	1,000
Subtotal	$1,000
Income	1,250
Subtotal	$2,250
Nondeductible expenses	(500)
Subtotal	$1,750
Deductible loss carried from Year 1 (limited to basis)	(1,750)
Ending basis	$ 0

The remaining deductible loss of $750 ($2,500 – $1,750) is carried over to Year 3.

The shareholder can make a formal election under Treas. Reg. §1.1367-1(f) to reduce basis by deductible losses and deductions before reducing basis by nondeductible items. The election is made by attaching a statement to a timely-filed original or amended return. Once made, this election is irrevocable for that year and all future years.

Caution. While it may seem that everyone should make this election, caution is advised. A shareholder who is currently limited to losses due to the at-risk rules must decide if it is more advantageous to carryover nondeductible or deductible expenses to the next year. If the shareholder expects to be in a higher tax bracket in future years, carrying the deductible expenses forward may produce better results, and the election should not be made.

Example 6. If Brandon, in **Example 5,** makes the Treas. Reg. §1.1367-1(f) election in Year 1, his basis is calculated as follows:

Beginning basis	$5,000
Deductible loss	(5,000)
Subtotal	$ 0
Nondeductible expenses	0
Ending basis	$ 0

The remaining deductible loss of $2,000 is carried to Year 2, as well as the $500 of nondeductible expenses.

In Year 2, Brandon made an additional contribution of $1,000 to BAB Corporation. The Schedule K-1 for Year 2 shows nonseparately stated ordinary income of $1,250 and nondeductible expenses of $500.

Beginning basis (from Year 1)	$ 0
Additions to capital	1,000
Subtotal	$1,000
Income	1,250
Subtotal	$2,250
Deductible loss (carried from Year 1)	(2,000)
Subtotal	$ 250
Nondeductible expenses carried from Year 1 (limited to basis)	(250)
Ending basis	0

The remaining nondeductible expenses of $750 ($500 + $500 – $250) are carried over to Year 3.

Temp. Treas. Reg. §1.469-2T(d)(6) addresses allocation of losses and deductions if the total is not allowed due to basis limitations. Although this regulation is found in the passive section[5] of the regulations, it addresses allocations for IRC §704 (partnerships) and IRC §1366 (S corporations). The losses and deductions must be prorated by comparing the individual amounts to the total amounts.

Example 7. Curtis invested $5,000 in an S corporation. His Schedule K-1 for the year shows $7,000 of nonseparately stated ordinary loss, $1,000 of §1231 loss, and $500 of nondeductible expenses. Prorating his losses results in the following basis adjustments:

Beginning basis	$5,000
Nondeductible expenses	(500)
Subtotal	$4,500
Deductible losses	(4,500)
Ending basis	$ 0

The nonseparately stated ordinary loss of $7,000 is divided by the $8,000 total deductible losses and then multiplied by the $4,500 allowed, resulting in a $3,938 loss allowed. The nonseparately stated loss carried to the following year is $3,062 ($7,000 less $3,938).

The §1231 loss of $1,000 is divided by the $8,000 total deductible losses and then multiplied by the $4,500 allowed, resulting in a $563 loss allowed. Finally, the §1231 loss carried to the following year is $437 ($1,000 less $563).

5. IRC §469

IRC §1244 stock losses are available if a shareholder has a loss from the disposition or liquidation of his entire S corporation interest. This treatment only applies to stock meeting the §1244 provisions; in particular, only the original contribution made in exchange for the stock is eligible for §1244 treatment.

Additional contributions to the capital of the S corporation do not qualify for §1244 treatment unless new shares are issued each time contributions are made. And, additional stock basis, such as from gains passed through on Schedule K-1, is not eligible for the §1244 stock treatment. The loss must be prorated between §1244 stock treatment and Schedule D treatment based on the investments.

Example 8. Peter invested $5,000 in PT Corporation, an S corporation, in Year 1. During Year 1, his Schedule K-1 showed a $3,000 gain. This increased Peter's basis to $8,000 ($5,000 + $3,000).

During Year 2, Peter's Schedule K-1 in PT Corporation showed $0. PT Corporation liquidated, and Peter received $4,000 in complete liquidation of his investment.

Peter has an investment of $8,000, of which $5,000 qualified for §1244 treatment. Peter's §1244 loss is $2,500 (($5,000 ÷ $8,000) × $4,000). The remaining loss of $1,500 ($4,000 – $2,500) is a Schedule D loss.

It also appears that any stock basis decreased due to losses or distributions is no longer eligible for §1244 stock treatment.

Example 9. Sylvia invested $5,000 in EP Corporation, an S corporation, in Year 1. During Year 1, her Schedule K-1 showed a $5,000 loss. This reduced Sylvia's basis to $0.

In Year 2, Sylvia's Schedule K-1 shows a $7,000 gain. This increases Sylvia's basis to $7,000.

At the end of Year 2, EP Corporation liquidated and Sylvia received $1,500. Sylvia reports a $5,500 loss on her Schedule D since she had a basis of $7,000 and only received $1,500. Sylvia cannot claim this as an §1244 loss because her original §1244 investment was eliminated with the loss from Year 1.

LOAN BASIS

An S corporation shareholder only has basis in loans **made directly by the shareholder to the S corporation**. This is not like a partnership, where the partner has a basis for his share of the partnership loans.

The **beginning basis** of loans in an S corporation is the amount loaned. When basis is reduced, stock basis is always reduced first. Only after stock basis is reduced to zero will loan basis be reduced.

When basis is restored, loan basis is restored first. Only after loan basis is restored to the full face amount of the remaining loan is stock basis restored. An exception to this rule is discussed later.

Treas. Reg. §1.1367-1(e) is generally followed when adjusting loans. However, the loan basis can never be higher than the remaining balance of the loan. **Loan basis** is:

1. **Increased by both taxable and nontaxable income items passed through** on the Schedule K-1 (including ordinary income, interest income, and net rental income);

> **Note.** After October 2001, nontaxable cancellation of indebtedness does not increase a shareholder's basis.

2. **Decreased by nondeductible expenses,** such as the 50% meals and entertainment expenses;
3. **Decreased by deductible losses and expenses,** such as charitable contributions, IRC §179 expense, and ordinary losses; and
4. **Decreased by loan repayments** to the extent nontaxable.

Each loan is considered separate as evidenced by individually written contracts. If there are no written instruments for the loans, they are treated as a single loan. If a shareholder has more than one loan, each loan's basis is reduced by a pro rata portion of the total reduction. The pro rata portion is based on the remaining basis of each loan compared to the total bases of all loans.

Example 10. Carol loaned $5,000 to her S corporation in 2004. Her stock basis was zero. Her **Schedule K-1 for 2004** showed $1,000 of nonseparately stated ordinary loss. This reduced her loan basis to $4,000 ($5,000 – $1,000).

During 2005, Carol made another loan of $6,000 to her S corporation, properly supported by separate loan documentation. Her **Schedule K-1 for 2005** shows a loss of $2,000. Her loan basis before the 2005 reduction is:

Loan 1	$4,000	(balance remaining of $5,000)
Loan 2	6,000	(balance remaining of $6,000)
Total basis	$10,000	

Loan 1 reduction = $800 (($4,000 ÷ $10,000) × $2,000).

Loan 2 reduction = $1,200 (($6,000 ÷ 10,000) × 2,000).

The new basis for each loan is as follows:

Loan 1	$3,200	(balance remaining $5,000)
Loan 2	4,800	(balance remaining $6,000)
Total basis	$8,000	

The restoration of basis in the loans is pro rata based on the total reductions that took place among the outstanding loans.

Example 11. Continuing with **Example 10**, Carol's **Schedule K-1 for 2006** shows $1,000 of income. Her basis in the loans is increased as follows:

Loan 1	$1,800	($5,000 balance – $3,200 basis)
Loan 2	1,200	($6,000 balance – $4,800 basis)
Total reductions	$3,000	

Loan 1 restoration = $600 (($1,800 reduction ÷ $3,000 total reductions) × 1,000 gain).

Loan 2 restoration = $400 (($1,200 reduction ÷ $3,000 total reductions) × 1,000 gain).

The new basis for each loan is as follows:

Loan 1	$3,800	($5,000 remaining balance)
Loan 2	5,200	($6,000 remaining balance)
Total basis	$9,000	

An S corporation's repayment of a shareholder loan does not result in income to the shareholder (other than interest) if the loan basis was not reduced. However, if loan basis is reduced, the repayment of a portion of or the entire loan results in shareholder income.

The percentage of the repayment that is not income is determined by dividing the loan basis by the loan's unpaid balance, and multiplying this percentage by the loan repayment. The remainder of the repayment is income.

Example 12. Donald loaned $5,000 to his S corporation in 2005. His stock basis was zero. His Schedule K-1 for 2005 showed $1,000 of nonseparately stated ordinary loss. This reduced his loan basis to $4,000 ($5,000 – $1,000).

During 2006, the corporation repaid $2,000 of this loan. Donald's Schedule K-1 showed $0 income. Donald's income from the repayment is calculated as follows:

$4,000 (loan basis) ÷ $5,000 (balance due on loan) = 80%

80% × $2,000 repayment = $1,600 nontaxable

$2,000 – $1,600 = $400 taxable income on repayment

If the S corporation had repaid the entire $5,000, the calculation would have resulted in $1,000 of taxable income, which matches the amount of losses taken in 2004 using the loan basis.

If there is income in the year of the repayment, the income is first applied to restore the loan basis before the calculation of any gain on the repayment.

Example 13. Arnold loaned $5,000 to his S corporation in 2005. His stock basis was zero. His Schedule K-1 for 2005 showed $1,000 of nonseparately stated ordinary loss. This reduced his loan basis to $4,000 ($5,000 – $1,000).

During 2006, the corporation repaid $2,000 of this loan. Arnold's Schedule K-1 showed $500 of income for the year. Arnold's income from the repayment is calculated as follows:

$4,000 (loan basis at end of 2005) + 500 (income for 2006) = $4,500 loan basis at end of 2006

$4,500 ÷ $5,000 (balance due on loan) = 90%

90% × $2,000 (repayment) = $1,800 nontaxable

$2,000 – $1,800 = $200 taxable income on repayment

The loan basis carried to the following year is reduced by the nontaxable portion of the repayment.

Example 14. Use the same facts as **Example 13.** The loan basis that Arnold carried to 2007 is $2,700. This is his former basis of $4,500 less the $1,800 of nontaxable repayment. The outstanding loan is $3,000 ($5,000 loan less $2,000 repayment).

The income from a loan repayment can be either capital gain, or ordinary income.[6] The income is capital gain if there is a written obligation to support the loan. It is long- or short-term depending on the length of time the note is held by the S corporation.

The income is ordinary income if there is no written note. The IRS has not identified where to report this income. Either Schedule E or Form 4797 is reasonable to use.

If more than one loan exists, the restoration of loan basis is first applied entirely to the loan that has been repaid, thereby reducing the gain from the repayment. Any remaining restoration is applied pro rata.[7]

6. IRC §1271(a)

7. Treas. Reg. §1.1367-2

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Example 15. Sharon made two $5,000 loans to her S corporation. Her bases in these two loans are $2,000 for Loan #1 and $3,000 for Loan #2 carried to Year 1. Her Schedule K-1 for Year 1 shows $500 of ordinary income. The S corporation repaid $1,000 of Loan #1.

Using the default rules results in a restoration of $300 basis to Loan #1 and $200 basis to Loan #2, before calculating the gain from the repayment. The gain on the repayment is $540 ($1,000 – (($2,300 ÷ $5,000) × $1,000 repayment).

Using this special provision, the entire $500 of ordinary income is used to restore Sharon's basis in Loan #1 to $2,500. The gain on the repayment is $500 ($1,000 – (($2,500 ÷ $5,000) × $1,000 repayment)).

A similar rule applies if the S corporation has income and the shareholder receives a distribution in that year. The stock basis is first restored up to the amount of the distribution. This reduces or eliminates the gain from the distribution. Any remaining restoration is applied to the loans pro rata.

Estate and Trust Basis

The basis issue for recipients of Form 1041, Schedule K-1, is far less complicated. Basis is not an issue until the assets of the estate/trust are distributed to the beneficiary. At that point, the beneficiary has a basis in the assets received. The basis that the estate/trust has in the asset is passed to the beneficiary. The **trust's basis** in contributed assets is the donor's adjusted basis. The **estate's basis** in an asset contributed at the date of death is generally the fair market value at the date of death. Form 1041, Schedule K-1, does not contain a capital account, or a record of loans, because neither of these categories affects the beneficiary.

Starting Basis for New Client

When a new client brings a Schedule K-1 to his tax preparer, he may or may not have documentation to verify a starting basis. However, it is necessary to know the taxpayer's basis. Without a basis determination, the IRS can argue the basis is zero. The most accurate way to reconstruct basis is to have all of the taxpayer's Schedules K-1, beginning with the initial year. It is also necessary to understand how the taxpayer obtained his interest.

The capital account section of Form 1065, Schedule K-1, shows the year's activity, including contributions and distributions. If the taxpayer is an original partner, his original contribution is included in the capital account.

If the **interest was purchased** from another partner, the purchase amount is the beginning basis. If the interest was gifted, the donor's basis is the starting point. If the **interest was inherited,** the fair market value at the date of death is generally used. Neither of these are included in the capital account on Schedule K-1.

An S corporation shareholder must know the amounts of the initial contribution, ongoing contributions and distributions. Unfortunately, Form 1120S, Schedule K-1, does not contain this information. Similar to partnerships, the shareholder must know the donor's adjusted basis for a gift, or the fair market value at the date of death for inherited interests.

PASSIVE LOSSES AND THE AT-RISK RULES

Even though the client has adequate basis to deduct pass-through losses, the losses may be limited by the passive loss rules. Prior to the application of passive loss rules, the at-risk rules must be followed. A taxpayer must be at-risk for a loss before the loss can be considered passive.

OVERVIEW OF AT-RISK RULES

When a Schedule K-1 reports an ordinary loss in box 1, it is tempting to report the loss without any further consideration. However, it is necessary to determine whether the taxpayer is allowed to utilize the loss. The ability of individuals and certain closely-held corporations to deduct losses is limited by the at-risk rules of IRC §465. In general, individuals may deduct their distributable share of losses only to the extent of the amount considered "at risk" with respect to the entity.

A taxpayer's at-risk amount is equal to the sum of:

1. The **amount of money contributed** and the adjusted basis of other property contributed to the partnership activity by the taxpayer, plus
2. **Amounts borrowed** related to the activity for which the individual partners have personal liability.[8]

If the loss exceeds the at-risk basis, the loss becomes a suspended at-risk loss. Form 6198, *At-Risk Limitations*, is used to monitor at-risk losses. The form is particularly helpful in later years when the loss reported on Schedule E, page 2, is greater than the loss shown on the current year Schedule K-1.

OVERVIEW OF PASSIVE LOSS RULES

In 1986, Congress passed legislation that created the passive loss rules of IRC §469. These rules substantially limited the benefits of an inactive investor. The passive activity rules apply to all rental activities and any other activity that does not involve material participation by the taxpayer.

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The shareholder/partner treats nonseparately stated income as active income if the shareholder/partner materially participates in the activity. If the shareholder/partner does not materially participate, the shareholder/partner's nonseparately stated income is considered passive.

The income from a passive activity is taxable, but the loss is only allowed in the current year up to the amount of passive income. Any disallowed loss is suspended until such a time as there is income from a passive activity, or the activity is disposed of in a taxable transaction.

Special rules apply to active participation in real estate activities. A taxpayer can deduct up to $25,000 of active participation real estate losses in the current year without passive income. This benefit phases out if the taxpayer's modified AGI is between $100,000 and $150,000.

Example 16. Mark invested $5,000 as a limited partner. The partnership incurred a loss in Year 1. Mark's $2,000 share of the business loss was reported on his Form 1065, Schedule K-1, in box 1. Mark is at-risk for the loss because his at-risk basis exceeds the loss. However, under the passive rules, Mark is not allowed a current deduction because he has no passive income. Form 8582, *Passive Activity Loss Limitations,* shows the limitation of the loss and suspends the loss for future years. By law, a limited partner cannot materially participate in the partnership and maintain his limited liability. Therefore, he is considered a passive investor.

In Year 2, Mark's share of the loss is $4,000. Since Mark's at-risk basis is $3,000 ($5,000 – $2,000), Mark is only at risk for $3,000 of the loss. The remaining $1,000 is a suspended at-risk loss. The $3,000 passive loss is also suspended because Mark has no passive income. Form 8582, *Passive Activity Loss Limitations*, reports a cumulative passive loss of $5,000, while Form 6198, *At-Risk Limitations*, reports the $1,000 suspended at-risk loss.

Passive Loss Rules Exceptions

Both real estate and personal property rental income pass through as separately stated items and are generally passive. It is not considered passive if the taxpayer qualifies as a real estate professional. The determination of a real estate professional is made at the taxpayer level. There is nothing reported on the Schedule K-1 to indicate the taxpayer is a real estate professional. If the taxpayer meets the criteria for real estate professional, the box on Form 1040, Schedule E, is checked informing the IRS that the entire loss is allowed, subject to at-risk limitations.

8. IRC §465(b)(1)

To be a real estate professional, an individual must perform more than:

- One-half of the personal services in trades or businesses that are real property trades or businesses, and
- 750 hours in real estate trades or businesses in which he materially participates.

Each rental real estate property is treated as a separate activity and the material participation test must be met separately. The taxpayer can make the election to treat all real estate activities as one if he cannot meet the material participation for some of the activities.

Real estate trades or businesses include real estate development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.[9]

Publicly Traded Partnerships

Publicly traded partnerships (PTP) are traded on an established securities exchange or a secondary market. PTPs report income on Form 1065, Schedule K-1. Box D in Part I is checked to indicate that the activity is a PTP. These activities report income on the Schedule K-1 in the same manner as any other partnership.

Special tax rules, similar to the passive activity rules, exist for PTPs.[10] Like passive activities, the loss from a PTP may not offset ordinary income. Even though passive activity losses (PAL) and PTPs are included in the same code section, the income or loss of a PTP may not offset the income or loss from another PAL or another PTP. Unlike passive activities, the income/loss from a specific PTP may only offset the income/loss of that particular PTP. Upon disposition of the PTP, the suspended losses may be deducted.

Example 17. John Q. Public owns PTP #1. This particular PTP engages in a business activity and a rental activity. The $5,000 income is offset by the $3,000 loss from rental activity. If the $3,000 rental loss was from a different PTP than PTP #1, the loss would be suspended until such time the other PTP had income.

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2007**

Department of the Treasury
Internal Revenue Service

For calendar year 2007, or tax year beginning ____________, 2007 ending ____________, 20____

Partner's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

B Partnership's name, address, city, state, and ZIP code

PTP Activity #1

C IRS Center where partnership filed return

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

F Partner's name, address, city, state, and ZIP code

John Q Public
Anywhere, USA

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss) **5,000**	15	Credits
2	Net rental real estate income (loss) **(3,000)**		
3	Other net rental income (loss)	16	Foreign transactions
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	17	Alternative minimum tax (AMT) items
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)	18	Tax-exempt income and nondeductible expenses
11	Other income (loss)		

9. IRC §469(c)(7)(C)

10. IRC §469(k)

Passive Activity Credits

The partnership, S corporation, and trust/estate Schedules K-1 all contain a box for credits. Partnership credits are reported in box 15. S corporation credits are reported in box 13. There are 16 letters (A–P) that identify specific credits for each activity. The letters used for both partnerships and S corporations are identical.

The estate/trust Schedule K-1 identifies credits in box 13. The letters identifying the credits for estates/trusts differ from those of partnerships and S corporations.

One credit that all these entities have in common is the low income housing credit. This credit is often associated with a passive activity. Passive activity credits are allowed even when a loss on the Schedule K-1 is not allowed due to passive limitations. Passive activity credits are allowed up to the individual tax liability on the unused $25,000 allowance. The $25,000 allowance is decreased by any amount already used in the current year for active participation activities, or the commercial revitalization deduction. The amount finally reported on the tax return depends on the individual's personal situation, considering AMT issues.

Example 18. Brenda is involved in a limited partnership that invests in real estate. The ability to take the low income housing credit made this investment attractive. Her Schedule K-1 from this passive activity shows a loss in box 2 of $5,000. Box 15, code A, reports a $600 credit. She is able to take advantage of the credit, assuming she has no other real estate activities to reduce the $25,000 allowance.

Example 19. Use the same facts as **Example 18,** except Brenda's Schedule K-1, line 2 reports a $28,000 loss, and box 15, code A reports a $1,000 credit. Because the loss ($28,000) is greater than the passive activity allowance ($25,000), $3,000 of the loss and all of the $1,000 credit are suspended.

REPORTING SCHEDULE K-1 INFORMATION ON FORM 1040

Once it is determined the taxpayer does not have a problem with the basis, passive loss, or at-risk rules, it is time to transfer the K-1 information to the Form 1040. The tax preparer will again find that he needs to be careful before transferring. Certain deductions may be limited by other revenue code sections.

IMPACT OF GAINS AND LOSSES

The Schedule K-1 reports the individual taxpayer's share of gains and losses, income and expenses, and credits from the entity. The current effect of the gains or losses depends first on whether the individual is an active or passive investor. If the individual materially participates in the entity, she reports the Schedule K-1 items on her tax return. Profits increase taxable income immediately, and losses either reduce taxable income currently or create a net operating loss (NOL). NOLs generally may be carried back two years and/or forward 20 years to benefit the taxpayer.

Profits and losses further affect the taxpayer by increasing or decreasing the basis of the activity. This basis increase or decrease ultimately affects the taxpayer when she disposes of her interest in the activity.

SPECIALLY ALLOCATED ITEMS

A partnership may allocate gains, losses, and deductions in a manner other than using the partners' profit and loss sharing ratio. For example, if two partners equally own the partnership, the allocations are normally 50–50. However, due to the bases of items contributed on formation, partnership gains and losses on the sale of assets and depreciation may be allocated differently.[11]

When a partnership interest is inherited, its basis is stepped-up to the FMV of the assets at the date of death. This can be substantially higher than the bases of the assets inside the partnership. Therefore, if the partnership sells an asset and allocates the gain to the partners, the partner with the inherited interest is taxed on "phantom gain."

11. IRC §704(b)

Example 20. Christa inherits her mother's 40% interest in the Smith Sisters Partnership. At the time of death, the partnership equipment had bases totaling $15,000, with an FMV of $75,000. The outside basis of Christa's partnership interest is $30,000 ($75,000 × 40%).

The partnership sells a piece of equipment with a basis of $1,000, and an FMV of $10,000 shortly after Mother's death. It recognizes a gain of $9,000. Christa's Schedule K-1 reports her share of the gain, or $3,600 ($9,000 × 40%.) This is not equitable for Christa because her share of the asset was valued at $4,000 in the estate, and she would have no gain to report if she sold the asset as an individual.

In order to prevent this inequality, the IRS allows the partnership to make an IRC §754 election. This election allows a partner, who bought into or inherited a partnership interest, to adjust her basis so that the inside basis of the assets reflects the appreciation included in the outside basis of the partner. If this election is made, the partner may receive a larger portion of depreciation and other benefits because of the appreciated outside basis.

The §754 election, which encompasses IRC §§734 and 743, is **made at the partnership level,** not by the individual partner. Once made, the election affects anyone who buys or inherits an interest. It can lead to negative results.

Example 21. Assume the Smith Sisters Partnership in **Example 20** made a §754 election. Christa's K-1 reports her share of the gain from the asset sale of $4,000, and also reports ($4,000) in box 20, code W. A supplemental schedule attached to the K-1 shows that this is the additional basis attributable to Christa because of the §754 election. The net result is that there is zero taxable gain.

For Example 21

651107

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0099

Schedule K-1 (Form 1065) **2007**

Department of the Treasury
Internal Revenue Service

For calendar year 2007, or tax year beginning ________, 2007 ending ________, 20__

Partner's Share of Income, Deductions, Credits, etc. ► See back of form and separate instructions.

Part I Information About the Partnership

A Partnership's employer identification number

12-3456789

B Partnership's name, address, city, state, and ZIP code

Smith Sisters Partnership
212 Smith Street
Somewhere, IL 55555

C IRS Center where partnership filed return

Cincinnati, OH

D ☐ Check if this is a publicly traded partnership (PTP)

Part II Information About the Partner

E Partner's identifying number

999-99-9999

F Partner's name, address, city, state, and ZIP code

Christa Myers
11 Dead End Lane
Somewhere, IL 55555

G ☒ General partner or LLC member-manager ☐ Limited partner or other LLC member

H ☐ Domestic partner ☐ Foreign partner

I What type of entity is this partner? ________

J Partner's share of profit, loss, and capital:

	Beginning	Ending
Profit	0 %	40 %
Loss	0 %	40 %
Capital	0 %	40 %

K Partner's share of liabilities at year end:

Nonrecourse . . . . $________
Qualified nonrecourse financing . . $________
Recourse . . . . $________

L Partner's capital account analysis:

Beginning capital account . . . . $	0
Capital contributed during the year . $	6,000
Current year increase (decrease) . . $	4,000
Withdrawals & distributions . . . $	( )
Ending capital account . . . . $	10,000

☒ Tax basis ☐ GAAP ☐ Section 704(b) book
☐ Other (explain)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)		
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)		4,000
11	Other income (loss)		
12	Section 179 deduction		
13	Other deductions		
14	Self-employment earnings (loss)		
15	Credits		
16	Foreign transactions		
17	Alternative minimum tax (AMT) items		
18	Tax-exempt income and nondeductible expenses		
19	Distributions		
20	Other information	W	-4,000

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see Instructions for Form 1065. Cat. No. 11394R Schedule K-1 (Form 1065) 2007

For Example 21

Supplemental Information
Smith Sisters Partnership 12-3456789
For Christa Myers 555-55-5555
Box 20 Code W Basis increase on equipment sold due to IRC §754 election.

IRC §179 EXPENSE ELECTION

IRC §179 allows an immediate deduction of certain personal property purchased for use in the active conduct of a trade or business. The maximum allowance (ceiling) for 2007 is $125,000. The §179 deduction is limited at both the entity and individual level. This may create a problem in preparing an individual return because that individual may have §179 deductions coming from multiple sources. This can result in the taxpayer having potential §179 deductions in excess of the limitation.

The partnership Schedule K-1 reports the IRC §179 deduction in box 12, and the S corporation Schedule K-1 reports it in box 11. Form 1041, Schedule K-1, does not have a specific box for a §179 deduction because estates and trusts are specifically excluded from a §179 deduction, even if they operate a trade or business.[12]

The amount contained in boxes 11 or 12 of the appropriate Schedule K-1 reports the §179 expense that is passed through in the current year. The §179 deduction is also limited by taxable income. The **taxable income limitation** at the S corporation level is the S corporation's taxable income **increased** by wages the S corporation paid to the shareholders. It applies at the S corporation or partnership level before the amounts are entered on the Schedule K-1 and at the shareholder or partner level.

Practice Tip. When reviewing a Schedule K-1 at the shareholder level, it is important to check the taxable business income and the amount of IRC §179 expense. If the taxable income does not appear to justify the amount of the §179 expense, verifying the information by contacting the preparer of the Form 1120S is important.

Example 22. SO Corporation is an S corporation. It placed in service $20,000 of property eligible for §179 expensing. SO Corporation incurs a $30,000 business loss for the year. This includes $65,000 of deductions for wages paid to shareholders.

SO Corporation's taxable income for the §179 limitation is $35,000.

($30,000) loss + $65,000 wages to shareholders = $35,000

Therefore, SO Corporation can elect to pass through the entire $20,000 of §179 expense.

Example 23. Use the same facts as **Example 22**. SO Corporation has two 50% shareholders. Shareholder A receives $65,000 of wages and Shareholder B receives no wages.

Shareholder A's tax professional reviews a Schedule K-1 with $15,000 of business loss and a Form W-2 from the S corporation reporting $65,000. This results in $50,000 of business income, which appears to be enough to substantiate the Schedule K-1 pass through of the $10,000 of §179 deduction.

Shareholder B's tax professional reviews a Schedule K-1 with $15,000 of business loss and no Form W-2 from the S corporation. This results in $15,000 of business loss, which does not appear to substantiate the Schedule K-1 pass through of the $10,000 of §179 deduction. Unless the S corporation has provided information showing its calculation, such as a copy of the Form 1120S, this tax professional should clarify that the §179 deduction is correct.

12. IRC §179(d)(4)

Taxable income of a partnership is the aggregate income or loss of all active businesses operated by the partnership **increased** by guaranteed payments to partners.

Example 24. The Guys Partnership reports a $5,000 loss, and passes through a §179 deduction of $25,000. The partnership also reports guaranteed payments of $45,000. Therefore, the partnership has an income limitation of $40,000.

($5,000) loss + $45,000 guaranteed payments = $40,000

This allows the full $25,000 deduction, although the Schedule K-1 looks deceiving with an operating loss and a §179 deduction.

The shareholder or partner is not required to elect to use the §179 pass-through. However, the amount reduces the shareholder's or partner's basis in the entity, whether or not it is used.

The §179 limitation also applies at the shareholder or partner level. This includes the business income limitation, as well as the annual deduction limitation of $125,000. If the shareholder or partner has more than one pass-through business activity or a sole proprietor business, the total §179 amounts may exceed the annual limitation.

Disallowed §179 amounts due to the business income limitation derived from the taxpayer's sole proprietor business carry forward to succeeding years. However, total §179 deductions from the pass-through entity which exceed the ceiling are wasted.[13]

Example 25. Martin operates a sole proprietorship. He is also a 50% partner in two partnerships and materially participates in each. All the businesses are capital intensive.

Martin purchases a business machine for the sole proprietorship for $10,000. He wishes to expense the machine to reduce his self-employment income.

Both of the other partnerships utilized the full §179 deduction of $108,000 (2006). Martin is limited to $108,000, even though the cumulative §179 deduction would have been $118,000.

In the Schedule C business, Martin has some control over the expensing deduction because he could choose not to expense the machine. However, he does not have the same control over the other entities in which he participates.

If the sole proprietorship had been a 50% partnership, Martin would have exceeded the total ceiling available without any opportunity to save the current benefit.

Example 26. Emma is a shareholder in three S corporations. During 2006, when the §179 limitation was $108,000, each corporation properly elected, calculated, and passed through the maximum §179 expensing. Emmas Schedule K-1 from each corporation reflected $40,000 of §179 expense for a total of $120,000 ($40,000 × 3 Schedules K-1).

Since the annual ceiling limitation was $108,000, Emma must choose which amounts to use from which corporations. Emma must still reduce her basis in each corporation by the $40,000 of §179 expense even though she cannot use $12,000 of the §179 deduction.

There is a controversial point related to the §179 deduction. IRC §179(b)(3) limits the deduction to taxable income derived from active participation in the activity. If this was a passive activity, would the passive partner or shareholder be entitled to a §179 deduction passed through from the activity? Treas. Reg. §1.179-2(c)(ii) states that it is the intent of the law to prohibit "mere passive investors in a trade or business" from benefiting from the §179 deduction. A partner is considered to actively participate in the partnership if the partner is meaningfully involved in management or operations. A limited partner would not meet that definition. The activity of an LLC member must also be examined.

13. Rev. Rul. 89-7, 189-1 CB 178

Over the years, the IRS has won many cases in which they denied the §179 deduction because of lack of meaningful taxpayer participation. In *Reynolds v. Comm'r,*[14] an attorney/accountant who worked as a supervisory internal revenue agent was denied the §179 deduction on a van which was allegedly used in his farming business. The court found that even if the farm had qualified as a business, it did not appear that the agent meaningfully participated in the activity.

The regulations do not go so far as to require **material participation.** Therefore, it appears that a taxpayer could have a §179 deduction from a passive activity which may be suspended as long as the taxpayer **meaningfully participates** in the activity, but does not meet the material participation test.

> **Example 27.** Kelly owns a beauty salon as a sole proprietor. She is not a beautician and does not work in the salon in that capacity. She hired Wanda, her chief beautician, who manages the shop and the other beauticians on a daily basis. Kelly participates in management decisions by meeting with Wanda to review developments and to approve the annual budget. Wanda does the hiring and firing, ordering, bill paying and all other day-to-day activities. Kelly bought new chairs for the salon at a cost of $3,000. Kelly's income from the business was $8,000 before any expensing. She is allowed to expense the cost of the chairs because she meets the **meaningful participation** test even though she would not meet the **material participation** tests.[15]

> **Note.** The §179 deduction does not apply to activities engaged in for the production of income such as rental activities.

Disposition of §179 Property

If a pass-through entity disposes of property expensed under §179, the entity does not report the sale of the asset on its return. The information necessary to complete the Form 4797, *Sale of Business Property,* is reported to each partner/shareholder as supplemental information.

Schedule K-1, box 20 contains "Other Information" and includes the codes A–E. Code E pertains to dispositions of property with IRC §179 deductions.

The S corporation or partnership separately lists:

- **Depreciation allowed or allowable** for the property not counting any §179 expense deduction;
- **The IRC §179 expense deduction** previously reported on Schedule K-1 to the shareholder; and
- **The description, purchase date, sales date, and sales price** of the disposed property.

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14. *Charles and Beatrice M. Reynolds v. Comm'r*, TC Memo 2000-20, January 19, 2000, *aff'd* 296 F.3d 607 (7th Cir. 2002)

15. Treas. Reg. §1.179-2(c)(iii)

Example 28. DG Corporation is an S corporation with two equal shareholders, Cole and Emma. DG Corporation purchased equipment for $30,000 in Year 1. DG Corporation elected a §179 expense of $24,000. It correctly passed this through to its shareholders, claiming $857 of depreciation for the remaining $6,000 ($30,000 – $24,000) of basis for Year 1. In Year 2, DG Corporation sold the property for $28,000 and claimed another $735 of depreciation.

Because DG Corporation is an S corporation, the Form 4797 is not completed and the property ownership percentage of each item is passed through to the shareholders who report the sale on their returns. Each 50% shareholder receives the following:

Equipment purchased Year 1	$15,000
Sold Year 2	14,000
Depreciation allowed or allowable	796
§179 passed through in Year 1	12,000

Cole claimed the §179 pass through on his Year 1 Form 1040 return. Consequently, he shows $12,796 ($796 + $12,000) as his depreciation allowed/allowable on line 22 of Form 4797. His gain from the sale of this equipment is $11,796 ($14,000 – ($15,000 – $12,796)).

Emma did not claim the §179 pass through on her Year 1 Form 1040 return. Therefore, she shows $796 as her depreciation allowed/allowable on line 22 of Form 4797. She reports a loss on the sale of this equipment of $204 ($14,000 – ($15,000 – 796)).

CHARITABLE CONTRIBUTIONS

S corporations and partnerships may pass through charitable contributions made by the entity. The entity must identify the appropriate classification of the deduction on Schedule K-1.

The "Other Deduction" box for both the partnership (box 13) and the S corporation (box 12) contains the deduction amount, and the corresponding letter identifying the specific classification of the charitable contribution. The following **codes** are identical for both the S corporation and the partnership:

Code A. Cash contributions subject to the 50% of AGI limitation for individuals

Code B. Cash contributions subject to the 30% of AGI limitation for individuals

Code C. Noncash contributions subject to the 50% of AGI limitation for individuals

Code D. Noncash contributions subject to the 30% of AGI limitation for individuals

Code E. Capital gain property contributed to a 50% organization and subject to the 30% of AGI limitation for individuals

Code F. Capital gain property subject to the 20% of AGI limitation for individuals

The S corporation or partnership must also provide each shareholder/partner with the information necessary for the shareholder to complete his personal Form 8283, *Noncash Charitable Contributions*, if needed.

If the total noncash contributions for any item or group of similar items are over $5,000, the entity must provide a copy of Form 8283 to each shareholder/partner. This is the case even if the shareholder/partner's pro rata portion is smaller than $5,000.

IRC §199 — DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

The §199 domestic production activities deduction can affect the individual Form 1040 whenever a pass-through entity is involved in a qualifying activity. In 2007, the deduction is even more valuable because the deduction increased to 6% from 3%.

The necessary information to calculate the deduction must be included on the Schedule K-1. It is reported on Form 8903, *Domestic Production Activities Deduction.*

To report the §199 deduction, the following codes appear for Schedule K-1 for Form 1065 and Form 1120S:

	Form 1065 in Box 13	Form 1120S in Box 12
Domestic production activities information	Code S	Code O
Qualified production activities income	Code T	Code P
Employer's Form W-2 wages	Code U	Code Q

Note. Additional information on the domestic production activities deduction can be found in Chapter 13 of the 2006 *University of Illinois Federal Tax Workbook.*

Wages

In addition to the increase in percentage, there is a major change in the way §199 wages are treated in 2007. Originally, partners and S corporation shareholders were limited to the lesser of their allocable share of the entity's Form W-2 wages, or two times the applicable percentage for the year of the qualified production activity income (QPAI) allocated to the partner or shareholder. The taxpayer then combined this amount with any W-2 wages reported from his or his spouse's business and any other K-1s in order to determine the §199 wage limit.

The regulations issued on May 17, 2006, remove the "2 times" pass-through limitation. Instead, the partnership or S corporation reports the partner/shareholder's share of total qualified wages paid by the entity. Prior to 2007, the taxpayer could use wages other than those directly connected with the qualifying activity when calculating his §199 deduction. For example, if he had a sole proprietor business which was not a qualifying activity, but paid W-2 wages, those wages could have been combined with the K-1 wages. For years beginning after May 17, 2006, only wages from a **qualifying activity** may be used to compute the §199 deduction.

Example 29. Brenda owns 50% of Kitchen Gadgets partnership, in which she actively participates. In addition, she has a sole proprietor business which manufactures kitchen knives. Her husband, Bob, is a sole proprietor barber who employs three stylists. Their **2006 wages** are:

	Total 2006 Wages	§199 Wages
Kitchen gadgets (Brenda's K-1)	$150,000	$ 6,000
Brenda's Schedule C	10,000	10,000
Bob's Schedule C	20,000	20,000
Total	$180,000	$36,000

The partnership wages are limited to the lesser of QPAI times (2 × 3%) or wages. The limitation equals $6,000 ($100,000 QPAI × (2 × 3%)). Even though Bob's barbershop does not qualify for a §199 deduction, the wages he paid can be used when calculating total wages. Therefore, Brenda can use $36,000 of wages to calculate the deduction.

Example 30. Use the same amount as show in **Example 29**, except use the **2007 wage limitation rules.**

	Total 2007 Wages	§199 Wages
Kitchen gadgets (Brenda's K-1)	$150,000	$150,000
Brenda's Schedule C	10,000	10,000
Bob's Schedule C	20,000	0
Total	$180,000	$160,000

Brenda can now use her entire share of $150,000 of partnership wages but cannot use Bob's nonqualifying barbershop wages of $20,000. Therefore, she can use total wages of $160,000 when calculating the deduction.

Interaction with Taxpayer's Other Businesses

Under the final regulations for 2007, businesses with production activities and no wages can combine their positive income with those qualifying activities that incur a loss and have wages.[16]

Note. The 2007 §199 deduction is the lesser of the taxpayer's AGI or QPAI times 6%, or 50% of the qualified wages.

Effective Date for Final Regulations

The effective date for the changes brought about by the final regulations is generally tax years beginning on or after June 1, 2006. For tax years beginning on or before May 17, 2006, taxpayers may apply all of the provisions for the entire year. Taxpayers who wish to apply these rules early must apply **all** the rules, not just some.[17]

ENTITY DEBT FORGIVENESS

When a partnership is relieved of debt, the income is passed through to the partner. Form 1065, box 11, includes other income that is required to be separately stated. Code E — cancellation of debt — only appears on Form 1065, Schedule K-1. This is taxable income, unless the partner meets one of the provisions in IRC §108.

The exception under IRC §108 includes insolvency, bankruptcy, qualified farm indebtedness, and qualified real property business indebtedness. The partner must meet the conditions of one of the exceptions to avoid taxation. If the partnership meets an exception but the partner does not, such as insolvency, the income is still taxable to the partner.

The S corporation Schedule K-1 does not treat debt forgiveness as a separately stated item. The S corporation must determine whether it meets the exemption of IRC §108 at the entity level. If the income is deemed taxable, it is reported in box 1 or box 2 of the Schedule K-1.

ORGANIZATION FEES AND SYNDICATION COSTS

Expenses incurred by a partnership in creating the partnership must be capitalized.[18] Examples of expenses are organization costs and promoting the sale of an interest in the partnership, such as syndication fees.

16. Treas. Regs. §§1.199-1 through 9
17. Treas. Regs. §§1.199-1 through 8
18. IRC §709

The first $5,000 of **organization costs** may be immediately deducted. Any amount not deducted must be amortized over a period of not less than five years.[19] In order for an expense to qualify as an organization cost, it must have been incurred during the period beginning close to the start of the partnership's business and ending with the due date of the first tax return. These amortized expenses must be for the creation of the partnership, not for the operation or starting the operation of the partnership trade or business. The expense must be for an item normally expected to benefit the partnership for its entire life.[20] Examples of organization expenses that may be amortized over a 5-year period include; legal fees incident to the partnership's organization, accounting fees, and filing fees.

Syndication expenses may appear as an entry on the Schedule K-1. They are not deductible.[21] Consequently, they can be recovered only upon termination of the partnership. Syndication expenses are those connected with the issuing and marketing of partnership interests, including brokerage fees, registration fees, legal fees of the underwriter, preparation of a private placement memorandum for securities law purposes, printing costs, and so on.

SOCIAL SECURITY ISSUES

Partners are subject to self-employment (SE) tax on the partner's share of the business income. Box 14 contains information needed by the partner to calculate his SE taxes. Three codes are used in Form 1065, Schedule K-1, box 14:

Code A. Net earnings (loss) from self-employment, reported on Schedule SE, Section A or B, whichever is applicable

Code B. Gross farming or fishing income, used if the partner elects the optional farming/fishing SE tax calculation

Code C. Gross nonfarm income, used if the partner elects the optional nonfarming SE tax calculation

The amount of income subject to SE tax is included in box 14, code A. As a general rule, income subject to SE tax should be the total of the amounts contained in box 1 (ordinary business income), box 3 (other net rental income), and box 4 (guaranteed payments).

Limited partners are exempt from SE tax on income other than guaranteed payments (box 4) for services rendered.[22]

The SE taxation consequences of multi-member LLCs taxed as partnerships are not clear. Since the IRS does not recognize the LLC as a distinct entity, the SE consequences of the LLC are not clearly defined. However, when an LLC member **provides services** to the LLC, whether he is a manager or not, the income is subject to SE tax.[23]

The nonmanaging member of a member-managed LLC may have an argument for treating the income in the same way the limited partner does. The IRS proposed amending Treas. Reg. §1.1402(a)-2 to state that a limited partner is not subject to SE tax. However, service partners in a professional partnership will never be treated as limited partners. The amendment states that a partner is considered limited unless he:

1. Has personal liabilities for debts of the partnership by virtue of being a partner,
2. Has authority to enter into contracts on behalf of the partnership, **or**
3. Participates in the partnership's business for more than 500 hours annually.

A partner is treated as passive if he does not meet the material participation rules. A passive (not limited) partner is still subject to SE tax, regardless of his status as passive.[24]

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19. Treas. Reg. §1.709-1(b)
20. Treas. Reg. §1.709-2(a)
21. IRC §709
22. IRC §1402(a)(13)
23. Letter Ruling 9432018 (May 16, 1994)
24. *W. A. Price v. Comm'r,* TC Memo 1993-265, June 16, 1993

PARTNER FORM W-2

A dilemma can exist in dealing with partnerships. Occasionally, a tax practitioner will see a situation in which a partner has a Schedule K-1 and a Form W-2 from the same partnership. The IRS takes the position that a bona fide member of a partnership cannot be an employee for employment tax purposes. Money paid to the partner by the partnership is not considered wages.[25]

Therefore, if a taxpayer receives both a Form W-2 and a Schedule K-1 from the same partnership, the Form W-2 should be corrected to zero. This affects the partnership return by lowering the wage deduction and increasing the partnership income. The Schedule K-1 must also be amended. If the partner was treated as an employee, payroll reports must be amended and possibly pension contributions or fringe benefits may have been incorrectly given.

SPECIAL INDUSTRIES

GRAIN STORAGE COOPERATIVES

Grain cooperatives help farmers market their products. Farmer cooperatives are generally tax-exempt under IRC §521. Generally, farmers who join cooperatives do so to enhance their profit by increasing the revenue from farm products' sales and reducing the cost of necessary supplies and services. The farmer brings crops and animals to the cooperative to be sold and buys supplies and services from the co-op. The farmer generally receives or pays the market price for these items or services. After the cooperative sells the farm products or pays for the supplies, the excess is returned to the farmer on a prorated basis depending on his degree of participation. The excess is received in the form of patronage dividends or a share in the ownership of the cooperative assets. Some of the payments are cash payments in the current year, and others may be deferred for payment in future years. Members of cooperatives do not receive K-1s from the cooperative. These payments are reported on Form 1099-PATR.

In order to remain competitive, some cooperatives form joint ventures or alliances with farmers. Grain storage activity is often conducted by an LLC formed by the cooperative. The LLC members are farmers who purchase membership interests in the LLC. The purpose of ownership is to allow a farmer to have additional grain storage without incurring the expense of constructing his own facility. As an LLC member, the farmer receives a Schedule K-1.

The activity is structured such that the LLC enters into a contract with the cooperative to manage the grain storage facility. The cooperative is responsible for the income and expense. Therefore, the LLC has no income or expense from the grain storage operation. However, the LLC owns the assets of the activity, and it has depreciation which is passed through to the LLC members. The farmer receives a Schedule K-1 from the LLC showing only the depreciation.

The LLC is acting similar to a lessor of the storage facility to the cooperative. Since a rental activity is passive, losses are not allowed unless the farmer has other passive income. Generally, the farmer does not benefit currently from the depreciation of the LLC activity. The loss is deferred until the farmer has passive income, or sells the membership interest.

25. Rev. Rul. 69-184, 1969-1 C.B. 256, and CCA 200117003 (January 26, 2001)

The farmer has the opportunity to group certain activities.[26] The grain storage activity could be aggregated with the farming activity to create material participation of the entire activity including the LLC. In this way, the farmer is allowed a current deduction of the depreciation from the Schedule K-1. **Activities may be grouped for this purpose if the activities form an appropriate economic unit.** The IRS looks at five factors to determine whether the activity meets the economic unit criteria. The factors are:

- Similarities and differences in types of trades or businesses,
- The extent of common control,
- The extent of common ownership,
- Geographical location, and
- Interdependencies among the activities.

The activities need not meet all the factors. They are judged on a facts and circumstances basis. Once the grouping is made, the activities may not be regrouped unless there is a material change in the facts and circumstances.

Note. Some swine farmers have investments in sow LLCs. These investments are treated in a similar manner.

GAS AND OIL INVESTMENTS

An individual can be involved in the oil and gas industry as a general partner (working interest owner) or as a limited partner. That determination affects whether the pass-through items are treated as passive or nonpassive. A working interest is always treated as active income, even though the individual is not actually actively involved. The following information relates to small oil and gas producers known as independent producers. Their average daily production of crude oil or natural gas cannot exceed 1,000 barrels per day per entity.

The activity very often shows a loss until a well starts producing. Some wells never produce, and may be considered dry holes and later abandoned. There may be tangible costs and intangible costs involved with the activity. The tangible costs are treated as ordinary deductions reported in Schedule K-1, box 1. Intangible drilling costs (IDCs) must be separately identified.

The partnership must make the decision to expense or capitalize the IDCs. If the partnership capitalizes the costs, they are recovered through cost depletion. If the partnership elects to expense the IDCs, the partner has the opportunity to deduct the costs currently or to elect to amortize the expenses over five years. Separate notification is required on Schedule K-1, box 13, code I.

The decision to deduct the expenses currently carries alternative minimum tax (AMT) implications. An AMT adjustment is not necessary if the 5-year amortization is selected. The election to amortize the IDCs is made annually.[27]

Depletion

Cost or percentage depletion may be used by independent producers. Percentage depletion uses a rate of 15%, and must be computed at the partner level, not the partnership level. Partnerships may provide a tentative depletion deduction, but the real deduction may be subject to a 65% of taxable income limit for the partner.

Oil and gas investors may also qualify for industry credits that pass through on the Schedule K-1. The enhanced oil recovery credit is an example of one such credit. It is reported in box 15, code P, for “other credits.”

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26. Treas. Reg. §1.469-4

27. IRC §59(e)(4)

ESTATES/TRUSTS SCHEDULE K-1 ISSUES

Similar to S corporations and partnerships, an estate or trust can be a pass-through entity. However, an estate or trust can also be a taxpayer. The Schedule K-1 does not distinguish between a trust and an estate anywhere on the Schedule K-1, other than in its name. To understand the proper tax treatment, it is important to notice which entity is represented. The tax treatment of items may differ depending on which entity the Schedule K-1 represents.

Estates and trusts report all income and expenses on Form 1041, similar to the Form 1040 of an individual. After the calculations, the net income is carried to Schedule B, where the estate calculates its income distribution deduction (IDD). The IDD reduces the estate's or trust's income before the calculation of the entity level tax.

The IDD for a simple trust is always equal to the income of the simple trust. This is the case, because all current year income from a simple trust must be distributed. The IDD for a complex trust depends on the trust instrument.

Any income required to be distributed in the current year is deemed distributed. Any additional distributions made to the beneficiary are used in calculating IDD. The total of the required distributions and the additional distributions cannot exceed the beneficiary's share of the total IDD.

The IDD for an estate is determined in the same manner as a complex trust. Often an estate's creation document does not mention any required distributions; therefore, an estate's IDD is normally limited to the distributions actually made.

Depreciation and depletion are two items that an estate or trust can allocate to the income beneficiaries. This allocation normally must be a condition of the will or trust document. As a result of this allocation, it is possible for an estate or trust to effectively distribute a loss to the beneficiary.

The income from the estate or trust activity can be passed through to the extent of the IDD. This income is determined without regard to the depreciation/depletion allocated to the beneficiary. When the beneficiary reports both the income from the Schedule K-1 and the depreciation/depletion, the net result can be a loss. Beneficiaries are always considered passive when they have a loss from a Form 1041, Schedule K-1.

The IDD is allocated to each beneficiary based on his share of the income interest of the estate or trust. A beneficiary who receives a flat amount and does not share in the residual of the estate or trust will not normally receive any portion of the income. Consequently, this beneficiary will not normally receive a Schedule K-1.

When calculating the breakdown of the IDD, the expenses of the estate and trust must be allocated to the various types of income. Direct expenses must be allocated to the income to which they pertain.

A pro rata allocation of the indirect expenses must be made to items that have special tax treatment. This occurs to prevent a distortion of the different types of income. For example, an allocation of indirect expenses must be made to:

- Tax-exempt income, because it is not taxed;
- Qualifying dividends, because they have a special tax rate (capital gains rates); and
- Capital gains, because they have a special tax rate.

Many tax software programs break the IDD down into a simple pro rata share of each income item. For example, if interest income represents 60% of the gross income of the estate or trust, the programs allocate 60% of the IDD to interest income. This allocation is acceptable.

Administration losses are normally not allowed to be carried forward; therefore, any amount that exceeds the current year's income is lost. Any administration loss in the final year of the estate or trust is passed through to the beneficiaries as an "excess deduction on termination" on the Schedule K-1.

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0092

Schedule K-1 (Form 1041) **2007**

Department of the Treasury
Internal Revenue Service

For calendar year 2007,
or tax year beginning ________________, 2007
and ending ________________, 20 ______

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

► See back of form and instructions.

Part I Information About the Estate or Trust

A Estate's or trust's employer identification number

B Estate's or trust's name

C Fiduciary's name, address, city, state, and ZIP code

D ☐ Check if Form 1041-T was filed and enter the date it was filed
____/____/____

E ☐ Check if this is the final Form 1041 for the estate or trust

F ☐ Tax shelter registration number, if any ________________

G ☐ Check if Form 8271 is attached

Part II Information About the Beneficiary

H Beneficiary's identifying number

I Beneficiary's name, address, city, state, and ZIP code

J ☐ Domestic beneficiary ☐ Foreign beneficiary

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Part III Beneficiary's Share of Current Year Income, Deductions, Credits, and Other Items

1	Interest income	11	Final year deductions
2a	Ordinary dividends		
2b	Qualified dividends		
3	Net short-term capital gain		
4a	Net long-term capital gain		
4b	28% rate gain	12	Alternative minimum tax adjustment
4c	Unrecaptured section 1250 gain		
5	Other portfolio and nonbusiness income		
6	Ordinary business income		
7	Net rental real estate income	13	Credits and credit recapture
8	Other rental income		
9	Directly apportioned deductions		
		14	Other information
10	Estate tax deduction		

*See attached statement for additional information.

Note: A statement must be attached showing the beneficiary's share of income and directly apportioned deductions from each business, rental real estate, and other rental activity.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1041. Cat. No. 11380D **Schedule K-1 (Form 1041) 2007**

Form 1041, Schedule K-1 was redesigned in the same style as the partnership and S corporation Schedules K-1. Boxes replaced the lines that previously existed.

Box 1. Interest income, to be reported on the beneficiary's Schedule B, or directly on Form 1040, line 8a, if applicable

Box 2a. Ordinary dividends, to be reported on Schedule B, or directly on Form 1040, line 9a, if applicable

Box 2b. Qualified dividends, to be reported on Form 1040, line 9b

Box 3. Net short-term capital gain, to be reported on Schedule D, line 5

Box 4a. Net long-term capital gain, to be reported on Schedule D, line 12

Box 4b. 28% rate gain, to be reported on the Schedule D worksheet

Box 4c. Unrecaptured IRC §1250 gain, to be reported on Schedule D, line 19, and the related Schedule D worksheet

Box 5. Other portfolio income and nonbusiness income such as annuities, to be reported on Schedule E, page 1

Box 6. Ordinary or business income, to be reported on Schedule E, page 2

Box 7. Net rental real estate income, to be reported on Schedule E, page 2

Box 8. Other rental income

Box 9. Directly apportioned deductions. This box replaces lines 7a, b, and c on the old form, which contained the directly allocated portion of the depreciation, depletion, and amortization. A statement must be attached to the Schedule K-1 identifying which type of expense (A – depreciation, B – depletion, C – amortization) belongs to each type of activity (business or rental). This is necessary because differing documents may handle the allocation between the beneficiary and the estate/trust in different ways.

Box 10. Estate tax deduction includes the estate taxes paid on income that represents income in respect of a decedent (IRD). This is deducted on Schedule A, as a non-2% miscellaneous itemized deduction.

Box 11. Explained on following page under "Excess Deductions on Termination."

Box 12. Alternative minimum tax adjustment. This box contains a number of specific codes which identify any minimum tax adjustments for specific types of income or expenses, such as depreciation adjustments, basis adjustments resulting in differing qualified dividends, long- or short-term capital gains, or other exclusion items.

Box 13. Credits and credit recaptures. Any credits which are passed through to the beneficiaries are reported in this box. Credits, such as business credits including low-income housing, energy credits, nonconventional fuels credit, and specialty credits for employers affected by the hurricanes, are identified by codes. A credit for estimated taxes paid by the estate or trust may be passed through to the beneficiary through this box. Back-up withholding may also be indicated here, reported as payments by the taxpayer. Information necessary for the recapture of certain credits must also be indicated in this box.

Box 14. Other information. This box contains codes for other tax information necessary to complete the beneficiary's return. Information such as tax-exempt interest, information for the domestic production activity deduction, net investment income, and other information must be included. This box only contains space for numbers, therefore an attachment is necessary for other explanations.

Note. Additional information on estates and trusts is found in Chapter 6, "Death of a Taxpayer."

CAPITAL GAINS AND LOSSES

Capital gains are allocated to corpus unless the will or trust document states otherwise, or unless they are actually distributed. The actual distribution must be a common practice by the fiduciary. Capital gain distributions from mutual funds follow the same rules.

Losses are never passed through to the beneficiaries prior to the final return. They are held at the entity level and distributed as loss carryforwards in the final year.

CARRYFORWARDS — CAPITAL LOSS, NOLs

Losses, such as capital losses, net operating losses, and administration losses cannot be passed through to the beneficiaries except in the final year of the estate or trust.

Capital losses are used by the estate or trust to offset its income and the excess amounts are carried forward to the following year. For an estate, capital losses are only those created by the estate. The unused capital losses of the decedent at the time of death never pass to the estate. They are lost.

Net operating losses are used by the estate or trust against its income, with the excess carried back or forward. At termination, these are passed to the beneficiaries.

EXCESS DEDUCTIONS ON TERMINATION

When an estate or a trust terminates, there may be tax benefits that were not used during the entity's lifetime. These benefits are distributed to the beneficiaries on the final Schedule K-1. Box 11 contains codes A-E, which represent the specific types of deductions.

Code A. **Excess deductions.** These are expenses incurred in the final year which exceed income. They are treated by the beneficiary as a miscellaneous 2% item on Schedule A, line 22.

Code B. **Short-term capital loss carryover.** This is reported on Schedule D, line 5.

Code C. **Long-term capital loss carryover.** This is reported on Schedule D, line 12, and the corresponding worksheets used to determine the tax resulting from Schedule D.

Code D. **Net operating loss carryover — regular tax.** Any amount in this box would be entered as a negative number on Form 1040, line 21.

Code E. **Net operating loss carryover — minimum tax.** This amount is entered on Form 6251, line 27, to determine any minimum tax requirement.

RENTAL LOSSES

One distinction between a trust and an estate is the $25,000 allowance for active participation rental real estate activities. A trust does not have the advantage of the $25,000 allowance. However, the estate representing the deceased individual does.

SCHEDULE K-1 APPEARS TO BE INCORRECT OR IS MISSING

Common sense is important when working with Schedules K-1. Look at the amounts reported. If the client cannot answer the questions about the reported information, the preparer of the K-1 should be consulted.

ERRORS

The Schedule K-1 instructions state if a partner/shareholder believes the partnership/S corporation made an error on the Schedule K-1, the entity should be notified and asked for a corrected K-1. The partner/shareholder should not change any item on the K-1. He should ensure the entity sends a copy of the corrected K-1 to the IRS.

INCONSISTENT TREATMENT

There are times when the Schedule K-1 preparer will not agree with the partner/shareholder's tax practitioner. In that case, Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request*, can be used.

Form 8082 is used by certain partners, shareholders, or beneficiaries of a pass-through entity who disagree with the treatment of an item appearing on the Schedule K-1. It may also be used to report the taxpayer's share of an activity of a pass-through entity that did not issue a Schedule K-1.

This form is not used to report a change due to losses limited by the at-risk or passive rules. The form is **not** used by partners of partnerships composed of 10 or fewer individuals, decedent estates, or C corporations, where the partnership did not elect to be covered by the consolidated audit rules. Therefore, a partner in a small partnership needs to solve the reporting inaccuracy with the partnership itself.

The form is attached to the taxpayer's original or amended return. One form must be completed for each separate entity that is being reported.