Chapter 5: Schedule K-1

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Corrections were made to this material through January of 2012. No subsequent modifications were made.

Pass-through entities use Schedule K-1 to report the shareholder's/partner's share of the entity's income, deductions, credits, etc. The shareholder/partner, rather than the pass-through entity, is liable for any tax liability on their share of the pass-through entity's income. The shareholder/partner uses the Schedule K-1 information to report the various tax-related items on their income tax returns.

The amount of loss and deductions the shareholder/partner is eligible to claim may be less than the amount reported on Schedule K-1. It is the shareholder's/partner's responsibility to consider and apply any applicable limitations.

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 pass-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.** It is important to 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.** It is advisable to 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.

Unreimbursed partnership expenses from nonpassive activities are entered on line 28, column **h**, of Schedule E, *Supplemental Income and Loss,* and labeled "UPE" in column **a** of the same line. These expenses are **not** combined or netted against any other amounts from the partnership K-1, but are instead entered as separate line items on Schedule E.

Example 1. Terri Dogood is a partner in Terri's Tavern partnership. Terri's K-1 reports $10,000 of ordinary income. Terri paid $2,000 from her own funds for a partnership expense and was not reimbursed by the partnership. The K-1 income and unreimbursed expense are reported on Terri's Schedule E as follows.

Schedule E (Form 1040) 2010 Attachment Sequence No. **13** Page **2**

Name(s) shown on return. Do not enter name and social security number if shown on other side.	**Your social security number**
Terri Dogood	**333-44-5555**

Caution. The IRS compares amounts reported on your tax return with amounts shown on Schedule(s) K-1.

Part II **Income or Loss From Partnerships and S Corporations** **Note.** If you report a loss from an at-risk activity for which **any** amount is **not** at risk, you **must** check the box in column **(e)** on line 28 and attach **Form 6198.** See page E-2.

27 Are you reporting any loss not allowed in a prior year due to the at-risk or basis limitations, a prior year unallowed loss from a passive activity (if that loss was not reported on Form 8582), or unreimbursed partnership expenses? If you answered "Yes," see page E-7 before completing this section. ☐ **Yes** ☑ **No**

28	**(a)** Name	**(b)** Enter **P** for partnership; **S** for S corporation	**(c)** Check if foreign partnership	**(d)** Employer identification number	**(e)** Check if any amount is not at risk
A	**Terri's Tavern**	**P**	☐	**37-1234567**	☐
B	**UPE**	**P**	☐	**37-1234567**	☐
C			☐		☐
D			☐		☐

	Passive Income and Loss		**Nonpassive Income and Loss**		
	(f) Passive loss allowed (attach **Form 8582** if required)	**(g)** Passive income from **Schedule K–1**	**(h)** Nonpassive loss from **Schedule K–1**	**(i)** Section 179 expense deduction from **Form 4562**	**(j)** Nonpassive income from **Schedule K–1**
A					**10,000**
B			**2,000**		
C					
D					
29a Totals					**10,000**
b Totals			**2,000**		

30	Add columns (g) and (j) of line 29a	30	**10,000**
31	Add columns (f), (h), and (i) of line 29b	31	(**2,000**)
32	**Total partnership and S corporation income or (loss).** Combine lines 30 and 31. Enter the result here and include in the total on line 41 below	32	**8,000**

Part III **Income or Loss From Estates and Trusts**

33	**(a)** Name	**(b)** Employer identification number

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. When 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?

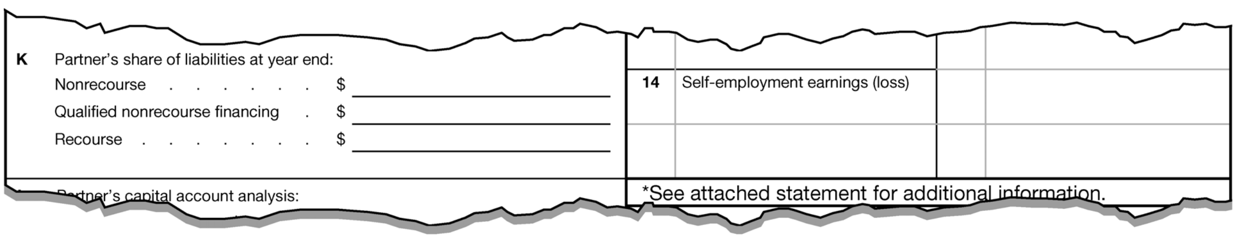
BASIS

It is essential to understand the concept of basis when reporting Schedule K-1 activity. 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 OUTSIDE LOANS ON PARTNERS/SHAREHOLDERS

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


K Partner's share of liabilities at year end:
Nonrecourse . . . . $
Qualified nonrecourse financing . $
Recourse . . . . $
Partner's capital account analysis:
14 Self-employment earnings (loss)
*See attached statement for additional information.

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.

State law may dictate whether a loan is recourse or nonrecourse. 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, partners can use the loan to increase their bases.

The S corporation K-1 does not disclose loans made by the S corporation because they generally do not affect the shareholder's basis. **However, shareholder loans made directly to the S corporation affect basis.**

Partners have both **inside** and **outside** basis. These amounts are normally the same unless the partner acquired an 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.

Partnership Basis Rules

A partner's **beginning basis** in the partnership is equal to:[2]

- The adjusted basis of contributed property, **plus**
- Cash contributed, **plus**
- Loans assumed, **minus**
- Loans contributed.

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1. Treas. Reg. §1.752-1(a)(2).
2. IRC §§722 and 752.

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 a share of the partnership loans.

Example 2. Kyle and Lonnie are forming an equal 50-50 partnership by contributing equal FMV of property. 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 transfers a mortgage on one of the assets of $40,000. Kyle's beginning partnership basis is $100,000, as shown below. Kyle's basis is reduced by the $40,000 mortgage he transferred, but it is increased by $20,000, his share of the mortgage once it was transferred to the partnership.

Kyle's adjusted basis of assets contributed	$100,000
Plus: cash contributed	20,000
Less: mortgage liability transferred	(40,000)
Plus: partnership debt assumed — Kyle	20,000
Kyle's initial basis	$100,000

Example 3. Continuing with **Example 2,** Lonnie contributes assets with a basis of $100,000 and a mortgage balance of $30,000. Lonnie's basis in the partnership is $105,000, as shown below. Lonnie increases his basis by his 50% share of the $40,000 mortgage transferred by Kyle.

In addition, Kyle has a new basis of $115,000 ($100,000 + $15,000) because he increases his basis by his 50% share of the $30,000 mortgage contributed by Lonnie.

Lonnie's adjusted basis of assets contributed	$100,000
Plus: cash contributed	0
Less: mortgage contributed	(30,000)
Plus: partnership debt assumed — Lonnie	15,000
Plus: partnership debt assumed — Kyle	20,000
Lonnie's initial basis	$105,000
Kyle's initial basis from **Example 2**	$100,000
Plus: partnership debt assumed — Lonnie	15,000
Kyle's revised initial basis	$115,000

In **Example 2** and **Example 3,** 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, the investor pays fair market value (FMV) for the interest. This can be substantially different than its basis.

Example 4. Lonnie sells one-half of his partnership interest in the Kyle–Lonnie Partnership from **Example 3** to Susan for $200,000. The purchase price of $200,000 is Susan's outside basis. Her **inside** basis is $52,500, one-half of Lonnie's basis.

A **general partner's** basis increases by the partner's share of recourse, nonrecourse, and qualified real property nonrecourse indebtedness. A **limited partner's** basis only increases by the partner's share of qualified real property nonrecourse indebtedness[3] or the amount of loans guaranteed by the limited partner.

Inside basis is the partner's basis in the partnership assets. **Outside basis** is the partner's basis in their partnership interest. While the **inside basis is tracked by the partnership,** the **outside basis must be tracked by the partner** or their tax preparer. When a partner sells a partnership interest, gain or loss is determined by the difference between the selling price and the **outside** basis.

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

Each partners' **capital account** is shown on their respective Schedule 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 partner's **at-risk amount** is the same as the basis, except the **debts included for at-risk purposes are only recourse and qualified real property nonrecourse debt.** The at-risk amount limits a taxpayer's losses. Unfortunately, the at-risk amount is commonly referred to as the taxpayer's basis for purposes of simplification.

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

1. **Increased by additional contributions to capital** (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, tax-exempt 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** (A decrease in the partner's share of debts is considered a distribution.)

Decreases other than distributions can never cause a partner's basis to fall below zero. Any portion 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 fall 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, *Capital Gains and Losses*. 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 deals with passive activities, 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.

Example 5. 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 is considered an ordinary loss.

S Corporation Basis Rules

S corporation shareholders do not have a basis adjustment resulting from corporation loans unless they directly loan the S corporation money. Even a personal guarantee by the shareholder does not increase basis.

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(f) 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, tax-exempt income, and net rental income);

> **Note.** Effective 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.

Stock basis cannot fall below zero. Any amount of losses or deductions in excess of basis is subject to the basis rules and is suspended until later year(s) when basis is restored. Form 6198, *At-Risk Limitations,* must be included with the tax return when there are losses larger than the taxpayer's at-risk amount.

Distributions in excess of stock basis 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. Because the excess distribution is treated as income, the basis becomes zero.

Example 6. 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[4] ordinary loss of $7,000 and nondeductible expenses of $500.

Following the ordering rule, Brandon's basis is calculated as follows:

Beginning basis	$5,000
Less: nondeductible expenses	(500)
Subtotal	$4,500
Less: deductible loss allowed	(4,500)
Ending basis for Year 1	$ 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.

Following the ordering rule, Brandon's basis is calculated as follows:

Beginning basis (from end of Year 1)	$ 0
Plus: additions to capital	1,000
Subtotal	$1,000
Plus: ordinary income reported for Year 2	1,250
Subtotal	$2,250
Less: nondeductible expenses	(500)
Subtotal	$1,750
Less: deductible loss carried from Year 1 (limited to basis)	(1,750)
Ending basis for Year 2	$ 0

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

4. Separately stated items of income, loss, deduction, or credit are those that could affect the liability for tax of any shareholder. Nonseparately stated income or loss means gross income minus separately stated items. See IRC §1366(a).

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 whose losses are currently limited because of the at-risk rules must decide if it is more advantageous to carry over 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 7. If Brandon, in **Example 6,** makes the Treas. Reg. §1.1367-1(f) election in Year 1, his basis is calculated as follows:

Beginning basis	$5,000
Less: deductible loss allowed	(5,000)
Subtotal	$ 0
Less: nondeductible expenses	(0)
Ending basis for Year 1	$ 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
Plus: additions to capital	1,000
Subtotal	$1,000
Plus: ordinary income reported for Year 2	1,250
Subtotal	$2,250
Less: deductible loss (carried from Year 1)	(2,000)
Subtotal	$ 250
Less: nondeductible expenses carried from Year 1 (limited to basis)	(250)
Ending basis for Year 2	$ 0

The **remaining nondeductible expenses of $750** ($500 Year 1 carryover + $500 Year 2 expenses – $250 used in Year 2) 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 section of the regulations deals with losses from passive activities,[5] it addresses allocations for §704 (partnerships) and §1366 (S corporations). The losses and deductions must be prorated by comparing the individual amounts to the total amounts.

5. IRC §469.

Example 8. Curtis invests $5,000 in an S corporation in 2011. His Schedule K-1 for 2011 shows $7,000 of nonseparately stated ordinary loss, $1,000 of §1231 loss,[6] and $500 of nondeductible expenses. Prorating his losses results in the following basis adjustments:

Beginning basis	$5,000
Less: nondeductible expenses	(500)
Subtotal	$4,500
Less: deductible loss allowed	(4,500)
Ending basis on December 31, 2011	$ 0

The nonseparately stated ordinary loss of $7,000 is divided by the $8,000 total deductible losses ($7,000 ordinary loss + $1000 §1231 loss) and then multiplied by the $4,500 allowed, resulting in a $3,938 loss allowed. The nonseparately stated ordinary loss carried to 2012 is $3,062 ($7,000 − $3,938).

The §1231 loss of $1,000 is divided by the $8,000 total deductible losses. It is then multiplied by the $4,500 allowed, resulting in a $562 loss allowed. Finally, the §1231 loss carried to 2012 is $438 ($1,000 − $562).

IRC §1244 provides that **losses from small business stock** are treated as **ordinary losses** for shareholders with losses from the disposition or liquidation of their 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. 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 a §1244 ordinary loss and a Schedule D capital loss based on the investments.

Example 9. 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 from PT Corporation showed $0 income/loss. PT Corporation liquidated, and Peter received $4,000 in complete liquidation of his $8,000 investment in the S corporation.

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

Any stock basis decreased to zero due to losses or distributions is no longer eligible for §1244 stock treatment.

Example 10. Sylvia invested $5,000 in EP Corporation, an S corporation, in Year 1. During Year 1, her Schedule K-1 showed a $5,000 ordinary loss. This reduced Sylvia's basis to $0.

In Year 2, Sylvia's Schedule K-1 shows $7,000 of ordinary income. 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 capital loss on her Schedule D because she had a basis of $7,000 and only received $1,500. Sylvia cannot claim the loss as a §1244 loss because her original $5,000 §1244 investment was eliminated by the $5,000 ordinary loss from Year 1.

6. IRC §1231 deals with property used in a trade or business and involuntary conversions.

LOAN BASIS

An S corporation shareholder only has basis in loans **made directly by the shareholder to the S corporation**. This is different from a partnership, in which partners have basis for their 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. After stock basis is reduced to zero, loan basis is then reduced as necessary.

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

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

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

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

- **Decreased by nondeductible expenses,** such as the 50% of meals and entertainment expenses
- **Decreased by deductible losses and expenses,** such as charitable contributions, IRC §179 expense, and ordinary losses
- **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 11. Carol loaned $5,000 to her S corporation in 2009. Her **stock basis** was zero. Her **Schedule K-1 for 2009** showed $1,000 of nonseparately stated ordinary loss. This reduced her loan basis to $4,000 ($5,000 – $1,000).

During 2010, Carol made another loan of $6,000 to her S corporation, properly supported by a separate loan document. Her **Schedule K-1 for 2010** shows an ordinary loss of $2,000. Her loan basis before the 2010 reduction is:

Loan 1	$4,000	($5,000 balance)
Loan 2	6,000	($6,000 balance)
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	($5,000 balance)
Loan 2	4,800	($6,000 balance)
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 12. Continuing with **Example 11,** Carol's **Schedule K-1 for 2011** shows $1,000 of ordinary income. The reductions in her loans before the 2011 restoration are 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 income).

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

The new basis for each loan is as follows:

Loan 1	$3,800	($5,000 balance)
Loan 2	5,200	($6,000 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 is not reduced. However, if loan basis is reduced, the repayment of all or part of the 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 13. Donald loaned $5,000 to his S corporation in 2010. His stock basis was zero. His Schedule K-1 for 2010 showed $1,000 of nonseparately stated ordinary loss. This reduced his loan basis to $4,000 ($5,000 – $1,000).

During 2011, 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 2010 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 14. Arnold loaned $5,000 to his S corporation in 2009. His stock basis was zero. His Schedule K-1 for 2009 showed $1,000 of nonseparately stated ordinary loss. This reduced his loan basis to $4,000 ($5,000 – $1,000).

During 2010, the corporation repaid $2,000 of this loan. Arnold's Schedule K-1 showed $500 of ordinary income for the year. Arnold's income from the repayment is calculated as follows:

$4,000 (loan basis at end of 2009) + $500 (income for 2010) = $4,500 loan basis at end of 2010

$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 15. Use the same facts as **Example 14.** The loan basis that Arnold carried to 2011 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.**[7] 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, *Supplemental Income and Loss,* or Part II of Form 4797, *Sales of Business Property,* may be used.

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.[8]

Example 16. Sharon made two $5,000 loans to her S corporation. Her bases in these 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 of Loan 1 is $540 ($1,000 repayment – (($2,300 loan basis ÷ $5,000 balance due on loan) × $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 now $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 **FMV** 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 new clients bring a Schedule K-1 to their tax preparer, they 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 the 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, the 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 FMV at the date of death is generally used. None of these beginning basis amounts 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 FMV at the date of death for an inherited interest.

7. IRC §1271(a).

8. Treas. Reg. §1.1367-2.

AT-RISK RULES AND PASSIVE LOSSES

Even when the client has adequate basis to deduct pass-through losses, the losses may be limited. If the at-risk rules are satisfied, the passive-loss rules are applied. 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 deduct 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.[9]

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 §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.**

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's/partner's nonseparately stated income is considered passive.

> **Note.** For more information about material participation, see the "Rental Activities" chapter in this book.

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 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 excess of passive income in the current year. This benefit phases out if the taxpayer's modified AGI is between $100,000 and $150,000.

Form 8582, *Passive Activity Loss Limitations,* shows the limitation of the loss and suspends the loss for future years. By law, **limited partners** cannot materially participate in the partnership and maintain their limited liability. Therefore, they are considered passive investors.

---

9. IRC §465(b)(1).

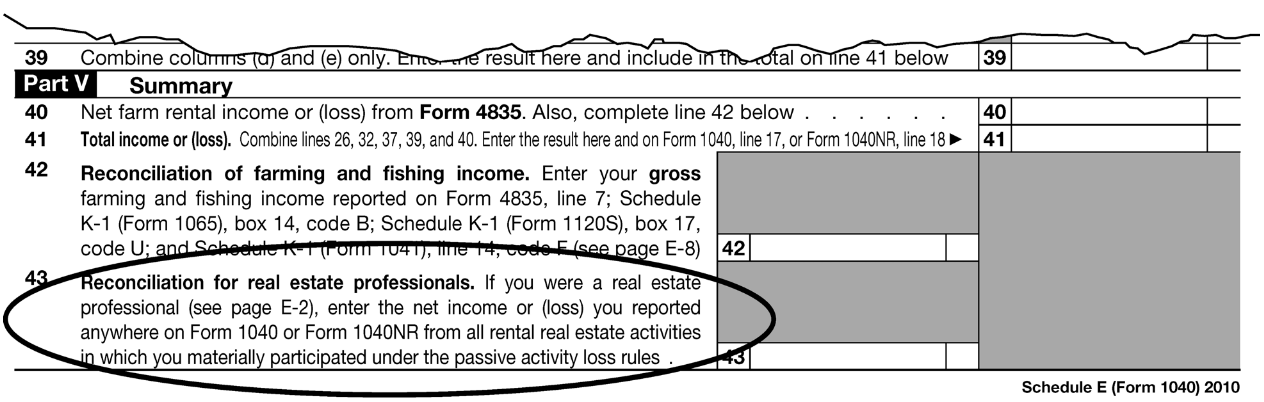
Example 17. Mark invested $5,000 as a limited partner. The partnership incurred a loss in Year 1. Mark's $2,000 share of the business loss was reported on his Form 1065, Schedule K-1, in Part III, box 1. Mark is at-risk for the loss because his at-risk basis exceeds the loss. However, under the passive rules, Mark is not allowed a current deduction because he has no passive income.

In Year 2, Mark's share of the loss is $4,000. Because Mark's at-risk basis is $3,000 ($5,000 investment – $2,000 Year 1 loss), 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.

Note. See the "Rental Activities" chapter in this book for more information about Form 8582.

Passive Loss Rules Exceptions

Both real estate and personal property rental income pass through and are reported on different lines on Schedule K-1 and are generally passive. The rental income 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, line 43 on Form 1040, Schedule E, is completed to inform the IRS that the entire loss is allowed, subject to at-risk limitations.



39	Combine columns (d) and (e) only. Enter the result here and include in the total on line 41 below	39
Part V	**Summary**	
40	Net farm rental income or (loss) from **Form 4835**. Also, complete line 42 below	40
41	**Total income or (loss).** Combine lines 26, 32, 37, 39, and 40. Enter the result here and on Form 1040, line 17, or Form 1040NR, line 18 ►	41
42	**Reconciliation of farming and fishing income.** Enter your **gross** farming and fishing income reported on Form 4835, line 7; Schedule K-1 (Form 1065), box 14, code B; Schedule K-1 (Form 1120S), box 17, code U; and Schedule K-1 (Form 1041), line 14, code F (see page E-8)	42
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see page E-2), enter the net income or (loss) you reported anywhere on Form 1040 or Form 1040NR from all rental real estate activities in which you materially participated under the passive activity loss rules .	43

Schedule E (Form 1040) 2010

To be a real estate professional, an individual must perform **more** than:[10]

- One-half of their personal services during the taxable year in trades or businesses that are real property trades or businesses in which the individual materially participates, and
- 750 hours in real estate trades or businesses in which the individual 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 they cannot meet the material participation test 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.[11]

10. IRC 469(c)(7)(B).

11. IRC §469(c)(7)(C).

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 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 special allowance for active participation real estate losses.

The $25,000 special 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 alternative minimum tax (AMT) issues.

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

Example 19. Use the same facts as **Example 18,** except Brenda's line 2 of Schedule K-1 reports a $28,000 rental real estate 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 the entire $1,000 credit are suspended.

REPORTING SCHEDULE K-1 INFORMATION ON FORM 1040

Once it is determined that the taxpayer is not affected by the basis, at-risk, or passive-loss rules, the Schedule K-1 information can be reported on the Form 1040. The tax preparer must be careful because certain deductions may be limited by other 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.

Profits increase taxable income immediately, and losses may reduce taxable income currently and/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 taxpayers by increasing or decreasing their basis in the activity. This basis increase or decrease ultimately affects taxpayers when they dispose of their interest in the activity.

SPECIALLY-ALLOCATED ITEMS

A partnership may allocate gains, losses, and deductions in a manner other than using the partners' profit-sharing or loss-sharing ratios. For example, if two partners equally own the partnership, the allocations are normally 50–50. However, because the basis of items contributed on formation of the partnership may be unequal, depreciation and partnership gains and losses on the sale of partnership assets may be allocated differently.[12]

12. IRC §704(b).

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 basis 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."

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

The partnership sells a piece of equipment for $10,000. It has a basis of $1,000 and an FMV of $10,000 shortly after Mother's death. The partnership recognizes a gain of $9,000. Christa's Schedule K-1 reports her share of the gain, which is $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. Therefore, she would have no gain to report if she had 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 their 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. IRC §754 is the election used to equalize inside and outside basis. IRC §§734 and 743 provide the formulas for the basis adjustment in the assets of the partnership.

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 $3,600, and also reports ($4,000) in box 20, with code Y. 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 Christa recognizes a $400 loss.

Note. If the partnership had not made the §754 election, Christa would not have been able to recognize the loss until she disposed of her partnership interest.

For Example 21

651111

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

Schedule K-1 (Form 1065) **2011**

Department of the Treasury
Internal Revenue Service

For calendar year 2011, or tax year beginning ________, 2011 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
22-2222222

B Partnership's name, address, city, state, and ZIP code
Smith Sisters Partnership
Theresville, IL 61111

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
444-55-4444

F Partner's name, address, city, state, and ZIP code
Christa Smith
Heresville, IL 60000

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 (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

K Partner's share of liabilities at year end:
Nonrecourse . . . . $ ________
Qualified nonrecourse financing . $ ________
Recourse . . . . $ ________

L Partner's capital account analysis:
Beginning capital account . . . $ ________
Capital contributed during the year $ ________
Current year increase (decrease) . $ ________
Withdrawals & distributions . . . $ (________)
Ending capital account . . . . $ ________

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

M Did the partner contribute property with a built-in gain or loss?
☐ Yes ☐ No
If "Yes," attach statement (see instructions)

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

1	Ordinary business income (loss)		15	Credits	
2	Net rental real estate income (loss)				
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)	**3,600**	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)				
12	Section 179 deduction		19	Distributions	
13	Other deductions		20	Other information	
			Y		**(4,000)**
14	Self-employment earnings (loss)				

*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) 2011**

For Example 21

Supplemental Information
Smith Sisters Partnership 22-2222222
For Christa Smith 444-55-4444
Box 20 Code Y Basis increase on equipment sold due to IRC §754 election.

IRC §179 EXPENSE ELECTION

IRC §179 allows an immediate deduction for the cost of certain personal property purchased for use in the **active conduct** of a trade or business. The maximum allowance (ceiling) for 2011 is $500,000. 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 the estate/trust operates a trade or business.[13]

The amount contained in box 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/partnership level before the amounts are entered on the Schedule K-1 and also at the shareholder/partner level.

Note. 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, it is important to verify the information by contacting the preparer of the Form 1120S.

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. The loss 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 justify the Schedule K-1 pass-through of the $10,000 §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 justify the Schedule K-1 pass-through of the pro rata $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 verify that the §179 deduction is correct.

13. IRC §179(d)(4).

The taxable income limitation 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 §179 deduction.

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

The §179 limitation also applies at the shareholder/partner level. This includes the business income limitation, as well as the annual deduction limitation ($500,000 for 2011). If the shareholder/partner has **more than one** pass-through business activity or a sole proprietor business, the total §179 amounts may sometimes 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. This carryover of the disallowed §179 deduction may be deducted in a future tax year.[14]

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 in 2011. He wishes to expense the machine to reduce his SE income.

Both of the other partnerships utilized the full §179 deduction of $500,000. Martin is limited to $500,000, even though the cumulative §179 deduction would have been $510,000.

In the sole proprietorship, 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 two partnerships in which he participates.

If the sole proprietorship had been a 50% partnership, Martin would have exceeded the $500,000 ceiling available without any opportunity to save the current benefit.

Example 26. Emma is a shareholder in three S corporations. During 2010, when the §179 limitation was $500,000, each corporation properly elected, calculated, and passed through the maximum §179 expense. Emma's Schedule K-1 from each corporation reflected $200,000 of §179 expense for a total of $600,000 ($200,000 × 3 Schedules K-1).

Because the annual ceiling was $500,000, Emma must choose which amounts to use from which corporations. Emma must still reduce her basis in each corporation by the $200,000 of §179 expense even though she cannot use $100,000 of the available §179 deduction.

There is a controversial issue related to the §179 deduction. IRC §179(b)(3) limits the deduction to taxable income derived from active participation in the activity. If the activity were a passive activity, would the passive partner/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.

14. Treas. Reg. §1.179-3(a).

The IRS has won many court cases in which it denied the §179 deduction because of lack of meaningful taxpayer participation. In *Reynolds v. Comm'r,*[15] an attorney/accountant who worked as a supervisory IRS 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 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 $3,000 cost of the chairs under §179 because she meets the **meaningful participation** test even though she would not meet the **material participation** tests.[16]

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.

Form 1120S, Schedule K-1, box 17, contains "Other Information" and includes the codes A–U. Code K pertains to dispositions of depreciable property for which the §179 deduction has been claimed. Form 1065, Schedule K-1, box 20, also lists "Other Information" and includes codes A – Y. Code L pertains to the disposition of §179 property.

The S corporation or partnership lists each of the following separately:

- **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
- **The description, purchase date, sales date, and sales price** of the property

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

16. Treas. Reg. §1.179-2(c)(iii).

Example 28. DG Corporation is an S corporation with two equal shareholders, Cole Jones and Emma Smith. DG Corporation purchased equipment for $30,000 on January 1, 2010. 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 2010. On November 30, 2011, DG Corporation sold the property for $28,000 and claimed another $735 of depreciation.

Because DG Corporation is an S corporation, 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 individual tax returns. Each 50% shareholder receives the following schedule:

Equipment purchased in 2010	$15,000
Equipment sale in 2011	14,000
Depreciation allowed or allowable	796
§179 expense passed through in 2010	12,000

Cole claimed the $12,000 §179 pass-through on his 2010 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)).

Part III of Cole's 2011 Form 4797 shows the following information.

Form 4797 (2011) **Cole Jones** **111-22-3333** Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A **Equipment**	**01/01/2010**	**11/30/2011**
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20	**14,000**			
21 Cost or other basis plus expense of sale	21	**15,000**			
22 Depreciation (or depletion) allowed or allowable	22	**12,796**			
23 Adjusted basis. Subtract line 22 from line 21	23	**2,204**			
24 Total gain. Subtract line 23 from line 20	24	**11,796**			
25 **If section 1245 property:**					

Emma did **not** claim the $12,000 §179 pass-through on her 2010 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)).

Part III of Emma's 2011 Form 4797 shows the following information.

For Example 28

Form 4797 (2011) **Emma Smith** **333-22-1111** Page **2**

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A	**Equipment**	**01/01/2010**	**11/30/2011**
B			
C			
D			

	These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20	Gross sales price (**Note:** *See line 1 before completing.*)	20	**14,000**			
21	Cost or other basis plus expense of sale	21	**15,000**			
22	Depreciation (or depletion) allowed or allowable	22	**796**			
23	Adjusted basis. Subtract line 22 from line 21	23	**14,204**			
24	Total gain. Subtract line 23 from line 20	24	**(204)**			
25	**If section 1245 property:**					

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 to complete their individual Form 8283, *Noncash Charitable Contributions,* if needed.

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

IRC §199 — DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

Note. A thorough explanation of §199 is beyond the scope of this chapter. For more information, see Chapter 13 in the 2006 *University of Illinois Federal Tax Workbook* and Chapter 15 in the 2005 *University of Illinois Federal Tax Workbook.* These chapters are available at **www.taxschool.illinois.edu/taxbookarchive**.

The §199 domestic production activities deduction (DPAD) applies to any business that manufactures, produces, grows, or extracts qualifying production property in the United States. For taxable years beginning in 2010 or later, the DPAD is generally 9% of the smaller of:

1. Qualified production activities income (QPAI), or
2. AGI for an individual, estate, or trust (or taxable income for all other taxpayers) figured without the DPAD.

However, the DPAD generally cannot be more than 50% of the Form W-2 wages paid to employees.

The §199 domestic production activities deduction can affect the individual's Form 1040 whenever a pass-through entity is involved in a qualifying activity.

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 are used on Schedule K-1 for Form 1065 and Form 1120S:

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

Wages

The partnership or S corporation reports the partner's/shareholder's share of total qualified wages paid by the entity. Prior to 2007, taxpayers could use wages other than those directly connected with the qualifying activity when calculating their §199 deduction. For example, if the taxpayer had a sole proprietor business which was **not a qualifying activity** but paid W-2 wages, those wages could be combined with the wages reported on Schedule K-1. 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, a 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 **2010 wages** are:

	Total 2010 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

The partnership wages are not limited by the QPAI. Bob's barbershop does not qualify for a §199 deduction, and the wages he paid cannot be used when calculating total wages. Therefore, Brenda can use $160,000 of wages to calculate the DPAD.

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 that pay wages.[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 exceptions under IRC §108 include 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, the cancellation-of-debt income is taxable to the partner.

The S corporation Schedule K-1 does not treat cancellation of debt as a separately stated item. The S corporation must determine whether it meets the IRC §108 exceptions at the entity level. If the cancellation-of-debt 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 such expenses are organization costs and promoting the sale of an interest in the partnership, such as syndication fees.

Taxpayers may generally elect to immediately deduct up to $5,000 of **organization costs.** Any amount not deducted must be amortized over a period of 180 months (15 years).[19] Costs in excess of $50,000 reduce the $5,000 deduction on a dollar-for-dollar basis. Therefore, no immediate deduction is allowed if the costs exceed $55,000. As a result, all of the cost must be amortized.

In order for an expense to qualify as an organization cost, it must be incurred during the period beginning near the start of the partnership's business and ending with the due date of the first tax return. These expenses must be incurred for the creation of the partnership, not for the operation or for 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 15-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 other similar expenses.

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17. Treas. Regs. §§1.199-1 through 9.
18. IRC §709.
19. Treas. Reg. §1.709-1(b).
20. Treas. Reg. §1.709-2(a).
21. IRC §709.

SOCIAL SECURITY ISSUES

Partners are subject to SE tax on the partner's share of the business income. Schedule K-1, box 14, contains information needed by the partner to calculate 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 reported in box 14, using code A. The §179 deduction in box 12 may reduce SE income.

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

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

The **nonmanaging member** of a member-managed LLC may have an argument for treating the LLC income the same way limited partners do. 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 stated that a partner is considered **limited** unless they:

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

Partners who do not meet the material participation rules are treated as passive partners. A passive (not limited) partner is subject to SE tax.[24]

PARTNER FORM W-2

A dilemma can exist when dealing with partnerships. Occasionally, a tax practitioner sees 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, employment tax returns must be amended and possibly pension contributions or fringe benefits may have to be reversed.

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22. IRC §1402(a)(13).
23. Ltr. Rul. 9432018 (May 16, 1994).
24. *W.A. Price v. Comm'r,* TC Memo 1993-265 (Jun. 16, 1993).
25. Rev. Rul. 69-184, 1969-1 CB 256, and CCA 200117003 (Jan. 26, 2001).

ESTATE/TRUST SCHEDULE K-1 ISSUES

Form 1041, Schedule K-1, uses the same style as the partnership and S corporation Schedules K-1.

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

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

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

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

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

Box 4b. Any 28% rate gain is reported on the Schedule D worksheet.

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

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

Box 6. Ordinary business income is reported on Schedule E, page 2.

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

Box 8. Other rental income

Box 9. For **directly apportioned deductions,** 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 various 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. Final year deductions are explained later in this chapter under "Excess Deductions on Termination."

Box 12. The **alternative minimum tax adjustment** 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. Any credits which are passed through to the beneficiaries are reported in the **credits and credit recaptures** box. Credits, which include estimated taxes, backup withholding, work opportunity credit, credit for small employer health insurance premiums, low-income housing, energy credits, and nonconventional fuels credit, are identified by codes. A credit for estimated taxes paid by the estate or trust may be passed through to the beneficiary using 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. The **other information** 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 activities deduction, net investment income, and other information must be included.

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

Schedule K-1 (Form 1041)
Department of the Treasury
Internal Revenue Service

2010

For calendar year 2010,
or tax year beginning ____________, 2010,
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

Part II Information About the Beneficiary

F Beneficiary's identifying number

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

H ☐ Domestic beneficiary ☐ Foreign beneficiary

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		
8	Other rental income	**13**	Credits and credit recapture
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) 2010**

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** are expenses incurred in the final year that exceed income. They are treated by the beneficiary as a miscellaneous itemized deduction subject to the 2% of AGI limitation on Schedule A, line 23.

Code B. **Short-term capital loss carryover** is reported on Schedule D, line 6, and the corresponding worksheets are used to determine the tax resulting from Schedule D.

Code C. **Long-term capital loss carryover** is reported on Schedule D, line 14, and the corresponding worksheets are used to determine the tax resulting from Schedule D.

Code D. Any amount in the **net operating loss carryover — regular tax** box is entered as a negative number on Form 1040, line 21.

Code E. The **net operating loss carryover — minimum tax** amount is entered on Form 6251, *Alternative Minimum Tax — Individuals,* 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 in rental real estate activities. A trust does not qualify for the $25,000 allowance. However, the estate representing the deceased individual does qualify.

SCHEDULE K-1 SEEMS INCORRECT OR IS MISSING

Common sense is important when working with Schedules K-1. If the client cannot answer the tax return preparer's questions about the reported information, the preparer of the Schedule K-1 should be consulted.

ERRORS

The Schedule K-1 instructions state that 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 form. The partner/shareholder should not change any item on the Schedule K-1. The partner/shareholder should ensure the entity sends a copy of the corrected Schedule K-1 to the IRS.

INCONSISTENT TREATMENT

There are times when the partner/shareholder's tax practitioner will not agree with the Schedule K-1 preparer about the treatment of items on the Schedule K-1. In that case, Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR),* 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 the activity of a pass-through entity that did not issue a Schedule K-1.

This form is not used to report a change that arises from 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's estates, or C corporations, in which the partnership did not elect to be covered by the consolidated audit rules. Therefore, a partner in a small partnership needs to resolve 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.

SCHEDULES K-1 WHEN DEATH OCCURS

In the year of death, an estate is automatically created by operation of state law. The taxable year in which a death occurs is divided into two periods, with each period requiring its own Schedule K-1. One Schedule K-1 reports items of income and gains or losses up to and including the date of death for the deceased individual. The other Schedule K-1 reports items of income and gains or losses for the estate. This Schedule K-1 for the estate shows amounts from the day after the date of death to either December 31 of the taxable year or, if the estate elected a fiscal year, the end of the first fiscal year.