Chapter 2: Individual Taxpayer Issues

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Note. Corrections were made to this workbook through January of 2023. No subsequent modifications were made. For terms used in this chapter, see the **Acronyms and Abbreviations** section following the index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

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DEPENDENCY ISSUES

The Code defines a dependent as a person who meets the tests to be either a qualifying child or a qualifying relative.[1] There are five significant tax benefits that rely on these definitions.

1. Dependency exemption[2]
2. Child tax credit (CTC)[3] and other dependents credit (ODC)[4]
3. Earned income credit (EIC)[5]
4. Child and dependent care credit (CDCC)[6]
5. Head of household filing status (HoH)[7]

> **Note.** For tax years 2018 through 2025, the dependency exemption deduction is zero for taxpayers and their dependents.[8] However, other tax benefits still require the taxpayer to be able to claim a person as a dependent as part of the tests for that benefit. For example, the education credits are tied to the dependency exemption.[9] In lieu of the dependency exemption, the CTC is expanded and taxpayers may claim the ODC for dependents who are not qualifying children.[10]

The benefits are attached to the qualifying person, and that person may only be used on **one** taxpayer's return. The **only** exception to the one-return rule is for **noncustodial** parents. Noncustodial parents may claim the dependency exemption and the CTC while the custodial parents use the same qualifying child for other benefits.[11]

Subject to the rules associated with each benefit, these five benefits are available to taxpayers who have one or more qualifying children. Some benefits are also available to taxpayers who have qualifying relatives. Additional rules and restrictions also apply to each benefit. To complicate matters, some of the additional restrictions only apply to dependents who are not qualifying children. Understanding which rules to apply requires that the practitioner classifies the potential dependent accurately.

1. IRC §152(a).
2. IRC §151.
3. IRC §24(c).
4. IRC §24(h)(4).
5. IRC §32.
6. IRC §21.
7. IRC §§2(b), 24(j)(2)(A)(iii)(II), 63(c)(2)(B), and 68(b)(1)(B).
8. IRC §151(d)(5)(A).
9. IRC §25A(f)(1)(A)(iii).
10. IRC §24(h)(4).
11. IRC §§152(e)(1) and (2).

Having the following information for each potential dependent is necessary to determine the classification of the person and the applicable rules for the various benefits.

- With whom the person lived during which periods of the year[12]
- The relationship between the person and the taxpayer and others in the home[13]
- The person's age[14]
- The person's income[15]
- The person's marital status at the end of the year[16]
- The source of the person's support[17]
- The person's citizenship and residency status[18]

Note. The age test may be met in certain circumstances if the person is disabled regardless of their age.[19]

This material is intended for practitioners familiar with the basic requirements for the tax benefits at issue. More information can be found in these IRS publications.

- **Filing status, CTC/ODC** — IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information,* IRS Pub. 504, *Divorced or Separated Individuals*
- **EIC** — IRS Pub. 596, *Earned Income Credit*
- **CDCC** — IRS Pub. 503, *Child and Dependent Care Expenses.*
- **Education credits** — IRS Pub. 970, *Tax Benefits for Education.*

UNIFORM DEFINITION OF QUALIFYING CHILD

Three tests always apply when determining if a person is a qualifying child under the uniform definition. The fourth and fifth tests only apply to certain benefits. For example, the support test does not apply to qualifying children for the EIC,[20] but it does apply to the CTC.[21]

12. IRC §152(c)(1)(B).
13. IRC §152(c)(2).
14. IRC §§32(c)(1)(A)(ii)(II); 152(c)(3).
15. IRC §32(c)(2)(A).
16. IRC §32(d)(2).
17. IRC §152(c)(1)(D).
18. IRC §32(c)(2).
19. IRC §152(c)(3)(B).
20. IRC §32(c)(3)(A).
21. IRC §24(c)(1).

The taxpayer must be able to answer "yes" to each of the following five tests for the child to be a qualifying child.

1. **Residency test.**[22] The child must reside in the same home as the taxpayer for at least six months of the year unless the taxpayer received a valid Form 8332, *Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent*.
2. **Relationship test.**[23] The taxpayer and the child must have a familial relationship including son, daughter, stepchild, adopted child, foster child, taxpayer's sibling or stepsibling, or a descendent of any of these.
3. **Age or disability test.**[24] The qualifying child must be under age 19 and younger than the taxpayer at the end of the year. Being a full-time student allows the dependency to continue while the child is younger than 24 at the end of the year. Individuals who are permanently and totally disabled at any time during the year are treated as meeting the age test.

> **Caution.** For some benefits, such as the CTC, the age test is lower.

4. **Joint return test.**[25] A qualifying child cannot file a married filing jointly (MFJ) return unless one is filed solely to claim a tax refund.
5. **Support test.**[26] The child must not provide more than half of their own support.

> **Note.** To determine the percentage of a child's support that a taxpayer provides, courts look at the amounts expended by the taxpayer compared to the amounts expended on the child's behalf from all sources. More specifically, "[s]upport provided by a third party, such as a [f]ederal or [s]tate agency, is not considered support furnished by the taxpayer."[27]

Identification Number Requirements

A qualifying child must have a social security number (SSN) to claim the CTC[28] and EIC[29] unless the child was born and died during the tax year. To claim the CTC and EIC for a deceased child who does not have an SSN, the taxpayer must attach to their return a copy of the child's birth certificate, death certificate, or hospital records showing a live birth.[30]

A child with an alternative identification number may be used for HoH, ODC, CDCC, and education credits. Acceptable alternative identification numbers include the adoption taxpayer identification number (ATIN) and individual taxpayer identification number (ITIN). The ATIN and ITIN must be issued prior to the return's due date, including extensions.[31]

> **Note.** For more information on the alternative identification numbers see **uofi.tax/22a2x1** [www.irs.gov/individuals/international-taxpayers/taxpayer-identification-numbers-tin].

22. IRC §152(c)(1)(B).
23. IRC §152(c)(2).
24. IRC §152(c)(3).
25. IRC §152(c)(1)(E).
26. IRC §§152(a)(1) and (c)(1)(D).
27. *Tam N. Huynh v. Comm'r*, TC Memo 2002-237 (Sep. 23, 2002).
28. IRC §24(h)(7); IRS Pub. 17, *Your Federal Income Tax for Individuals*.
29. IRC §32(c)(3)(D)(i); IRS Pub. 596, *Earned Income Credit (EIC)*.
30. IRS Pub. 17, *Your Federal Income Tax for Individuals* and IRS Pub. 596, *Earned Income Credit (EIC)*.
31. IRS Pub. 17, *Your Federal Income Tax for Individuals.*

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INTRODUCTION TO SCENARIOS

Sometimes children may qualify more than one taxpayer for certain tax benefits. The following three comprehensive scenarios illustrate how dependency issues affect tax outcomes in nontraditional situations.

- **Scenario 1.** Unmarried parents living together with qualifying child
- **Scenario 2.** 3-generation household
- **Scenario 3.** Divorced or separated parents living apart

SCENARIO 1: UNMARRIED PARENTS LIVING TOGETHER WITH QUALIFYING CHILD

Tyler and Raven live together as a couple but are not married to each other or anyone else. They have a child, Kennedy, age 15, who lives with them. No one else lives in their household. Kennedy does not provide over half of her own support, she does not file a joint return, and she is a U.S. citizen. She is a qualifying child, but at issue is who may claim the exemption for her.

Filing Status

From the facts given, it is likely that either Tyler or Raven probably qualifies for HoH filing status. However, because the parents live together, the tax benefits for having a qualifying child may not be divided between the two taxpayers.[32] Accordingly, the taxpayer who qualifies as HoH is only allowed to claim HoH if the other parent does **not** claim Kennedy as qualifying child for the other benefits. If the parent who is **not** the HoH claims Kennedy, both taxpayers must file as single.

The HoH is the taxpayer who provides over half of the costs of the home. It may be simple to make that determination if one parent's income is significantly more than the other's income. However, in situations where their income is comparable, it may be necessary to determine who pays the expenses using the following worksheet from IRS Pub. 17, *Your Federal Income Tax for Individuals.*

Worksheet 2-1. **Cost of Keeping Up a Home**

Keep for Your Records

	Amount You Paid	Total Cost
Property taxes	$	$
Mortgage interest expense		
Rent		
Utility charges		
Repairs/Maintenance		
Property insurance		
Food eaten in the home		
Other household expenses		
Totals	$	$
Minus total **amount you paid**		(____________)
Amount others paid		$
If the total amount you paid is more than the amount others paid, you meet the requirement of paying more than half of the cost of keeping up the home.		

> **Note.** This test for **filing status** purposes uses **actual expenses** for the cost of property taxes and mortgage interest. For **dependency purposes**, the test to determine who provides the most support uses the **fair market value (FMV)** of the lodging. Thus, for filing status purposes, it does not matter who owns the home, but for support purposes, it does.

32. IRS Pub. 504, *Divorced or Separated Individuals*.

Tax Credits and Deductions

Whoever claims Kennedy may qualify for the CTC or the EIC. If Kennedy is disabled and requires constant attention, they might also qualify for the CDCC.[33]

Issues to Consider

The CTC and the EIC phase out based on the income and filing status of the taxpayer claiming the child. For tax years 2018 through 2025, the CTC phases out for taxpayers with modified adjusted gross income (MAGI) above $200,000 ($400,000 MFJ).[34]

> **Note.** The CTC was enhanced for 2021.[35] The phaseout of the enhanced credit began at $75,000 for singles, $112,500 for HoH, and $150,000 for MFJ and qualifying widow(er) (QW). These special phaseout rules do not apply during 2022 for calendar year taxpayers.

EIC is based on a percentage of the taxpayer's earned income.[36] The percentage is based on the number of qualifying children claimed. Above certain income levels, this credit phases out. The phaseout occurs at higher income levels for taxpayers filing MFJ. The EIC tables are adjusted for inflation annually. For 2022, taxpayers with one child who do not file MFJ receive the maximum EIC when their earned income is between $10,980 and $20,130; the credit is completely phased out when income exceeds $43,492.[37]

Maximizing Tax Benefits

For 2021, Tyler and Raven's tax preparer calculates each return with and without Kennedy as the taxpayer's qualifying child. The results appear in the following table without consideration of the advance child tax credit received.

	Option 1			Option 2		
	Tyler	**Raven**	**Combined**	**Tyler**	**Raven**	**Combined**
Filing status	Single	Single		Single	HoH	
Kennedy as qualifying child	With	Without		Without	With	
Earned income/adjusted gross income (AGI)	$15,000	$120,000		$15,000	$120,000	
Less: standard deduction	(12,550)	(12,550)		(12,550)	(18,800)	
Taxable income	$ 2,450	$107,450		$ 2,450	$101,200	
Income tax (from tax tables)	$ 246	$ 19,809		$ 246	$ 16,857	
Less: CTC	(3,000)	(0)		(0)	(2,600)	
Less: EIC	(3,618)	(0)		(980)	(0)	
Net tax after credits	($ 6,372)	$ 19,809	$19,809	($ 734)	$ 14,257	$14,257
			(6,372)			(734)
Combined tax liability			$13,437			$13,523

33. IRS Pub. 503, *Child and Dependent Care Expenses.*

34. IRC §24(h)(3).

35. IRC §24(i) provides special CTC rules, but only for 2021.

36. IRC §§32(a)(1) and (b)(1).

37. Rev. Proc. 2021-45, 2021-48 IRB 768; IRS Pub. 596, *Earned Income Credit (EIC)* contains amounts for 2021.

Conflicts[38]

If Tyler and Raven agree on who claims Kennedy, there is no conflict and no need to apply the tie-breaker rules. However, if they cannot agree, the child is treated as the qualifying child of the parent with whom the child resided for the longest time during the year. If the child resided with both parents for the same amount of time, the parent with the highest AGI wins the tie-breaker test.

If both Tyler and Raven file returns claiming Kennedy as their qualifying child, Raven is treated by the IRS as the only taxpayer with a qualifying child because her AGI is higher than Tyler's. The determining factor is AGI because both Tyler and Raven are Kennedy's parents, and Kennedy lived with both for the same number of days during the year.

SCENARIO 2: 3-GENERATION HOUSEHOLD

Paula owns a home where she lives with her daughter, Monica, and her grandson, Logan. Logan is Monica's son and is three years old. Monica is 25, and Paula is 47. Logan's biological father is not present.

Paula earns $150,000 a year, and Monica earns $20,000. Monica pays her student loans and other personal expenses from her income, but Paula pays all household expenses for the family. Logan meets all the tests to be a qualifying child for both Monica and Paula.

Filing Status

Only Paula qualifies to file as HoH because she provides all costs of maintaining their home. If Paula claims Logan, she may also qualify for CDCC and CTC. Her income is too high for EIC. She must file using single filing status if she does not claim Logan.

If Monica claims Logan, she qualifies for CDCC, CTC, and EIC. Because she does not qualify for HoH filing status, she must use single filing status regardless of who claims Logan.

Issues to Consider

- It does not matter who pays for Logan's support if there are no external sources of support.[39] To be a qualifying child, the only support test is that Logan does not provide over half of his own support. If Logan does not provide more than half his own support, he may be either Monica's or Paula's qualifying child.
- Monica would not be able to claim a qualifying child **if** she were also a qualifying child.[40] However, Monica does not meet the age test to be a qualifying child, unless she is permanently and totally disabled. Therefore, Monica is able to claim Logan as a qualifying child.
- The Code says that if an individual can be claimed as a qualifying child by two or more taxpayers, the individual is treated as the qualifying child of the parent.[41] Monica is Logan's parent, not Paula. Although the parent has priority in claiming an individual as a qualifying child, this is not required. However, the Code also states that if the parents do **not** claim the child, another qualified taxpayer may if that taxpayer's AGI is higher than that of the parent.[42]

38. IRC §152(c)(4)(B).
39. *Tam N. Huynh v. Comm'r*, TC Memo 2002-237 (Sep. 23, 2002).
40. IRC §152(b)(1).
41. IRC §152(c)(4)(A)(i).
42. IRC §152(c)(4)(C).

- If income levels were reversed and Monica's AGI was higher than Paula's, Logan would **not** be Paula's qualifying child. Thus, Paula would **not** be able to claim any of the tax benefits related to Logan.

Observation. Logan would not meet the tests to be Paula's qualifying **relative** either, because Logan meets the tests to be Monica's qualifying child.[43] For more information on qualifying relatives, see IRS Pub. 501.

- If Paula claims Logan, Monica qualifies for EIC as a single person with no qualifying children. The IRS changed its position on this in 2017.[44] Having a qualifying child does **not** preclude a taxpayer from claiming EIC for taxpayers without a qualifying child if that child is claimed on another return.[45]

SCENARIO 3: DIVORCED OR SEPARATED PARENTS

Maria, a tax practitioner, has an appointment with Kelsey. Kelsey brings in her tax documents and her ex-husband's tax documents so that as a family they can achieve the most advantageous tax results. From prior years Maria has the following information.

- Kelsey is a single mother and the only adult in her household. She has two children, Roy and Terry. The children travel at will between their mother's home and their father's home.
- Kelsey and the children's father, Mike, divorced in 2015. He pays child support and alimony to Kelsey according to the terms of their divorce decree, although they share joint custody. Mike's companion, Penny, lives with him in the home he shares with his children. The following table illustrates the living situation.

Household 1	Children		Household 2
Kelsey (mother, divorced, not remarried)	Roy (age 8)	Terry (age 19)	Mike (father) Penny (partner)

From this information, Maria plans the following four steps for her due diligence.

1. Review and retain a copy of the divorce decree if not on file.
2. Ask if any new court decrees have been issued regarding the terms of the alimony or custody.
3. Inquire if anyone has remarried or acquired any new members of their households.
4. Obtain written consent from all taxpayers to advise them as a group despite the inherent conflicts of interest in assisting both parents.

At the appointment, Maria learns that Mike and Penny celebrated New Year's Eve 2022 with an intimate gathering to witness their marriage by a licensed minister. Other than the change in marital status for Mike and Penny, there are no changes affecting members of the households or court orders.

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43. IRC §152(d)(1)(D).

44. 82 Fed. Reg. 6379 (Jan. 19, 2017).

45. IRS Pub. 596, *Earned Income Credit.*

Issue to Consider 1: Applying the Qualifying Child Requirements[46]

To address this issue, Maria must evaluate the following factors, identified earlier in the section covering the uniform definition of a qualifying child.

- **Residency** — The children share the same principal abode for more than half of the year with one of their parents, but Maria needs to determine which parent.
- **Relationship** — The children meet the relationship tests for Kelsey and Mike. Now that Mike and Penny are married, they also meet the relationship test for Penny.
- **Age** — At age 8, Roy meets the age test. At age 19, Terry only meets the test if he is a full-time student for at least five calendar months during the year, or is permanently and totally disabled.
- **Joint Return** — Neither child is married, so this test is not applicable.
- **Support** — The children do not provide over half of their own support.

Residency. The IRS defines the **custodial parent** as the one with whom the child lived for the greater number of nights during the year. A special exception addresses parents who work nights.[47]

Kelsey asks if it makes a difference that Terry moved to Champaign in June to attend the University of Illinois. He started attending school as a full-time student in August. Maria explains that being away at school is a temporary absence. While away, he is treated as living with the parent with whom he normally would be living those nights.[48]

Neither Kelsey nor Mike keeps a calendar recording where the boys sleep each night. However, the family uses Kelsey's address as the children's home of record for school and medical purposes. The fact that Kelsey receives child support bolsters the conclusion that the children's residence is the same as their mother's.

Tax Credits. After Maria establishes that the children reside with Kelsey, she explains that based on income and other factors, the following tax credits related to the children may be available to Kelsey or Mike.

- **CTC/ODC.** The CTC applies to Roy, under age 17,[49] while the ODC applies to Terry, who is over age 16.[50] These credits are generally available to either custodial or noncustodial parents, assuming that the additional tests for noncustodial parents are met.[51] Mike meets the additional tests because of the following facts.
  1. He and Kelsey are divorced.
  2. Kelsey, Mike, and Penny[52] (collectively "the parents") provided over half of the children's support for the year.
  3. The children were in the custody of their parents for more than half of the year.
  4. Kelsey has agreed to sign Form 8332 for any child they decide Mike should claim.

> **Note.** In 2021 **only,** the cutoff age for the CTC was 18.[53]

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46. IRC §§32(c)(3) and 152(c).
47. Treas. Reg. §1.152-4(d)(5).
48. Treas. Reg. §1.152-4(d)(3)(i).
49. IRC §24(c).
50. IRC §24(h)(4).
51. IRC §152. See also IRS Pub. 504, *Divorced or Separated Individuals.*
52. IRC §152(e)(6).
53. IRC §24(i).

- **CDCC.** The CDCC[54] applies to Roy, who is under age 13, if the taxpayer paid for his care while they were working or looking for work. However, only the custodial parent qualifies, so only Kelsey qualifies to take the credit even if Mike had to pay for daycare expenses while he worked.
- **EIC.** The EIC for taxpayers with a qualifying child is only available to the custodial parent.[55]
- **American Opportunity Credit/Lifetime Learning Credit.[56]** The American Opportunity Credit (AOC) and lifetime learning credit may be available for education expenses paid by the family for Terry's attendance at the University of Illinois. Only the taxpayer who claims the dependent can claim the education credit; however, that taxpayer may claim the credit for qualified expenses regardless of who actually paid the expenses.

Note. Education credits may be claimed by student taxpayers who do not claim themselves if no one else claims them either.[57] For more information about education credits, see the 2019 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Maria notes that as the custodial parent, Kelsey qualifies for all the tax benefits assuming the other requirements are met. If Kelsey chooses, she may release the exemptions for either or both children to allow Mike to claim the tax credits for the dependents (CTC and ODC) and the education credits (AOC or lifetime learning credit). Kelsey still qualifies to claim CDCC and EIC if she releases the exemption. Because the dependent and education credits are subject to phaseout provisions, Maria must wait until she has finished the other tax return data input to determine the best collective outcome. She builds the following table to keep track of which tax credit is associated with which parent.

Custodial Parent Only	Custodial or Noncustodial Parent
CDCC (Roy)	CTC (Roy), ODC (Terry)
EIC (Roy and Terry)	AOC/Lifetime Learning Credit (Terry)

Issue to Consider 2: Kelsey and the HoH Requirements

Maria knows that Kelsey qualifies to file HoH. Maria has already verified that the children are qualifying children who lived with Kelsey for more than half of the year. Maria has also verified that Kelsey did not remarry during the year, and no other person provided support to the household.

Kelsey mentions she is considering changing jobs and asks if the money she receives from Mike counts against her when determining if she provides over half of the costs of maintaining the household for the year. Maria hedges:

> *Well, the actual law requires that you "maintain" a household.[58] The regulations define maintaining as "paying" more than half of the cost of the household.[59] The court cases I have read only apply to the support questions for the dependency purposes. The IRS publication[60] says that you can still claim head of household even if you receive child support or alimony, just as long as you're covering more than half of the costs. Because the alimony is taxable to you, I am sure that would count as your money you pay to maintain the household. I wouldn't worry about it.*

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54. IRS Pub. 503, *Child and Dependent Care Expenses.*
55. IRC §32(c)(3)(A).
56. IRS Pub. 970, *Tax Benefits for Education.*
57. Ibid.
58. IRC §2(b).
59. Treas. Reg. §1.2-2(d).
60. IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information.*

Issue to Consider 3: Tax Consequences of Alimony[61]

Kelsey wants to know why her friend, Betsy, does not have to pay taxes on her alimony. Maria explains that Kelsey and Mike's divorce agreement was executed before 2019. The rules changed for divorce agreements executed after 2018. Maria suggests that she discuss with her attorney returning to court and asking that the agreement be modified expressly to state that the alimony is not deductible by Mike and is not taxable to Kelsey. Kelsey declines to pursue this, saying she was just curious.

> **Note.** For more information about the tax implications of alimony, see the 2018 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 5: Divorce. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Issue to Consider 4: Mike's Filing Status

Marital status is determined on the last day of the tax year.[62] Therefore, Mike and Penny may file jointly or may file as married filing separately (MFS). Maria doubts filing separately is beneficial but makes a note to confirm this before completing the returns.

Issue to Consider 5: Education Credits[63]

Maria notes that Terry's college expenses may qualify for the AOC or the lifetime learning credit. She explains that although the traditional undergraduate college student attends school for five calendar years, the more advantageous credit, the AOC, can only be claimed four times for any one individual. If they cannot maximize the AOC this year, it may be beneficial to use the lifetime learning credit instead and save the AOC for his final year in school.

Maria asks Kelsey for Terry's Form 1098-T, *Tuition Statement*. Kelsey says she did not get one. Maria tells her that Terry probably received an electronic copy delivered to his online student account. She explains that basic due diligence requires she get a copy of the statement before she can finish the returns.

In the meantime, she verifies that none of the education expenses were paid with funds from qualified tuition programs, also known as IRC §529 plans. She explains that sometimes these accounts are established by grandparents who receive the tax documents when the money is distributed. She wants to ensure they are not "double-dipping" by using the qualified expenses to claim an education credit on the return she prepares while someone else uses the same qualified expenses to exclude the income. Kelsey assures her that no generous grandparents assist with Terry's college expenses with §529 funds or any other source.

Maria asks Kelsey if she kept receipts for books and course materials Terry purchased for his classes. She explains that the expenses might help increase the AOC if the credit is not already maximized using out-of-pocket tuition and fees paid by the family. If the net tuition is over $4,000, then Kelsey does not need to find the receipts because the extra expenses cannot increase the credit further.

Kelsey asks if the portion of the tuition paid by Terry's student loans counts towards the credit. Maria confirms that expenses paid with borrowed funds are still qualified. However, expenses paid by scholarships generally do not qualify.

> **Note.** See IRS Pub. 970 for examples showing how claiming otherwise tax-free scholarships in the student's income can increase the amount of expenses eligible for the education credits.

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61. IRS Pub. 504, *Divorced or Separated Individuals.*

62. IRS Pub. 501, *Dependents, Standard Deduction, and Filing Information*.

63. IRS Pub. 970, *Tax Benefits for Education.*

Conclusion

Maria prepares Kelsey's return using the HoH filing status. Kelsey claims Roy for the CDCC and the EIC purposes. She also claims Terry for EIC purposes. These credits are only available to the custodial parent. Even if Kelsey's income precludes her claiming the credits, she is the only taxpayer who may claim the children for these purposes.

Maria compares the effect of claiming the CTC for Roy and the ODC and AOC or lifetime learning credit for Terry on both the returns for Kelsey and for Mike and Penny. She looks into any advantage Mike and Penny may obtain by filing separately.

Maria is required to file Form 8867, *Paid Preparer's Due Diligence Checklist,* for Kelsey because she is filing as HoH. Maria must also complete the portions of the form related to EIC, CTC/additional CTC/ODC, and AOTC if Kelsey claims any of these credits. If Mike and Penny claim the dependency or education credits, Maria must also complete the form for their return.

PASS-THROUGH ENTITY TAX: PARTNERS AND SHAREHOLDERS[64]

Note. For information about the pass-through entity (PTE) tax election from the entity's perspective and on how the election may save taxes for an entity's owners, see the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues. A list of all states that have enacted PTE legislation as of the date this workbook went to press can also be found in that chapter.

The Tax Cuts and Jobs Act (TCJA) curtailed many tax benefits, but the limitation of the deduction for state and local taxes (SALT) was among the most painful for many. Starting January 1, 2018, the deduction for SALT on individuals' income tax returns is limited to $10,000 ($5,000 for MFS).[65]

Note. Different states may define qualified entity more inclusively. For example, according to IL Pub. 129, *Pass-through Entity Information,* fiduciaries are included as PTE. However, IRS Notice 2020-75, 2020-49 IRB 1453, only addresses partnerships and S corporations. Accordingly, these materials will only focus on partnerships and S corporations.

This limitation most affected taxpayers in states with high taxes, prompting their legislatures to find workarounds to the SALT limitation. One of the workarounds was the enactment of PTE taxes. These taxes shift the state tax liability **to** the PTE and **away from** the PTE's owners. The phrase **PTE owners** includes partners, S corporation shareholders, and members of limited liability companies (LLC) taxed as pass-through entities.

Residents of any state may have ownership interests in pass-through entities that do business in the states that have a PTE tax. Thus, practitioners in every state may have clients impacted by this tax. For example, the owner's state of residence **might** allow a credit for taxes paid to other states for the PTE tax.[66]

64. IRC §164(b)(6).

65. IRC §164(b)(6)(B).

66. *Wisconsin Enacts Election Permitting Pass-Through Entities to be Taxed at the Entity Level.* Jan. 2019. BDO. [www.bdo.com/insights/tax/state-and-local-tax/wisconsin-enacts-election-permitting-pass-through] Accessed on Jul. 8, 2022.

Not only does the PTE election avoid the SALT limitation, the PTE tax deduction at the entity level also may reduce the owner's AGI. Even a small reduction in an owner's AGI due to this election could benefit the owner in several ways. Many tax credits are subject to AGI tests such as the education credits[67] and the EIC.[68] A lower AGI can decrease taxable social security income[69] and increase allowable contributions to individual retirement arrangements (IRAs).[70] Lowering the AGI may also increase the allowable qualified business income deduction (QBID)[71] and amount of itemized deductions.[72]

Note. The Federal tax benefit of the PTE deduction can be diminished by the effect it has on QBID. This is because the deduction for PTE reduces qualified business income (QBI).

The election to pay PTE tax is made at the entity level. A PTE tax is based on that state's portion of taxable income passed through to the owners of the entity. Typically, each owner's personal income tax liability to that state is decreased by a credit passthrough by the entity.[73] In addition, the PTE can deduct the tax expense for federal purposes.[74] Thus, effectively, the deduction for the tax expense is moved from the owner's itemized deductions to the entity's business tax return. This shift happens regardless of whether the taxpayer actually itemizes.

Note. PTEs taxed as partnerships issue **Schedules K-1 (Form 1065),** *Partner's Share of Income, Deductions, Credits, etc.,* to report each partner's share of the partnership's earnings, losses, deductions, and credits. PTEs taxed as S corporations issue **Schedules K-1 (Form 1120-S),** *Shareholder's Share of Income, Deductions, Credits, etc.*, to report these items. Most states with filing requirements for PTEs have similar schedules for the entities to report items specific to that state to their owners.

The list below includes **midwestern** states that have enacted a PTE tax and the year it first went into effect or will go into effect.[75]

- Illinois (2021)[76]
- Kansas (2022)
- Michigan (2021)
- Minnesota (2021)
- Missouri (for tax years ending on or after December 31, 2022)[77]
- Ohio (2022)
- Wisconsin (2019, the first state in the midwest to pass a PTE tax)

67. IRC §25A(d).
68. IRC §32(a)(2)(B).
69. IRC §86.
70. IRC §219(g).
71. IRC §199A(c).
72. IRC §68.
73. *Where individual, corporate, and pass-through entity taxation meet.* Bell-Jacobs, Mo; McCann, Bridget; and Wlodychak, Steve. Jun. 1, 2021. The Tax Adviser. [www.thetaxadviser.com/issues/2021/jun/individual-corporate-passthrough-entity-taxation-meet.html] Accessed on May 11, 2022.
74. IRS Notice 2020-75, 2020-49 IRB 1453.
75. *SALT Parity*. Main Street Employers. [mainstreetemployers.org/salt] Accessed on Jul. 8, 2022.
76. IL Pub. 129, *Pass-through Entity Information.*
77. Missouri HB 2400 enacted Jun. 27, 2022.

Each state has approached the enactment of its PTE tax in its own way.[78] Some states incorporated aspects of similar laws previously passed by other states. Some states added unique provisions to their law. Practitioners are encouraged to become familiar with the state laws applicable to their clients' situations to determine the proper treatment of PTE items.

The examples that follow are meant to convey a general idea of how PTE tax can affect individual state returns. Comprehensive discussions for each state's provisions are beyond the scope of this workbook.

MISSOURI[79]

The state of Missouri passed its PTE tax in the summer of 2022. Introduced in the Missouri Senate under the name the SALT Parity Act, Missouri's revenue code[80] now states that each taxpayer, including part-year residents, that is subject to the state personal income tax shall be allowed a tax credit if such taxpayer is a member of an affected business entity that elects to pay the tax imposed by this act. **The tax credit shall be equal to the taxpayer's pro rata share of the tax paid under this act.** Such tax credit shall be **nonrefundable**, but may be carried forward to subsequent tax years, except that a tax credit authorized for taxes paid to other states shall not be carried forward.

Example 1. Sherri is the 100% LLC member of a Missouri-based business. The LLC elected to be taxed as an S corporation. In 2023, her business realizes profits of $100,000 that pass through to her personal income tax return. She does not have any other taxable income or deductions to report.

If the S corporation elects to pay the PTE tax for 2023, the effect is shown next, assuming the following tax factors apply.

- The standard deduction for a single taxpayer is $14,000.
- The federal income tax deduction for Missouri residents has been repealed (to avoid having to make assumptions about federal tax laws in effect in 2023).
- Personal tax brackets range from 0% to 6% with the highest bracket applying to incomes over $10,000.
- Missouri tax on the first $10,000 after applying all brackets is $400.[81]
- For illustration purposes, the owner's pass-through income from the entity subject to PTE tax is also equal to their adjusted Missouri income from the PTE. This is unlikely in practice because of how Missouri law determines these amounts.

78. *SALT Parity*. Main Street Employers. [mainstreetemployers.org/salt] Accessed on Jul. 8, 2022.

79. *Perfected.* Andrews, Jamie. Missouri Senate. [www.senate.mo.gov/22info/BTS_Web/Summary.aspx?SessionType=R&SummaryID=8683145&BillID=71455873] Accessed on Jul. 8, 2022.

80. Mo. Rev. Stat. §143.436.

81. 2021: $283 on first $8,704 = 3.252%. See *Individual Income Tax Year Changes*. Missouri Department of Revenue. [dor.mo.gov/taxation/individual/tax-types/income/year-changes] Accessed on Jul. 8, 2022.

Entity level	
Pass-through Missouri income subject to PTE tax	$100,000
Highest rate in effect for state personal income tax [82]	× 6%
Entity pays PTE tax	$ 6,000
Pass-through PTE tax credit	$ 6,000
Individual level	
Pass-through income ($100,000 − $6,000)	$ 94,000
Missouri income modification	6,000
Missouri AGI	$100,000
Less: standard deduction	(14,000)
Missouri taxable income	$ 86,000
Owner tax ((6% × $86,000) − $400) [83]	4,760
Pass-through PTE tax credit	(6,000)
Tax (credit carryforward)	$ (1,240)

Note. Practitioners with specific questions on how to handle **the PTE tax from another state on a Missouri return** can contact the Missouri Department of Revenue via an email addressed to **corporate@dor.mo.gov** with "Pass through entity taxes" in the subject line.[84] This contact information is only for this specific topic.

ILLINOIS[85]

The election to pay Illinois PTE tax is available for tax years ending on or after December 31, 2021, and beginning before January 1, 2026. In Illinois, individual owners are allowed a tax credit equal to their share of the PTE tax. The credit is refundable.

The Illinois Schedule K-1-P, *Partner's or Shareholder's Share of Income, Deductions, Credits, and Recapture*, provides each owner of the entity with the information they need to properly report the entity's pass-through activity on their Illinois income tax return. Schedule K-1-P includes state modifications, the PTE tax credit, and pass-through withholding.

Example 2. Chris owns 100% of an S corporation doing business in Illinois. The corporation's only 2021 pass-through income was $100,000 of long-term capital gains. The company reports its income on an accrual basis. Thus, the $6,450 in tax ($4,950 PTE tax + $1,500 replacement tax) reported on its 2021 Illinois corporate return is equal to the amount of state taxes deducted from ordinary income.

Chris' only reportable income for 2021 was from the Schedule K-1 (Form 1120-S). The federal Schedule K-1 reports the $100,000 on line 8a and the $6,450 tax as a loss on line 1 as shown next. Chris' federal AGI is $93,550.

82. Missouri HB 2400.

83. Currently 0% to 5.4% with highest bracket applying after only $8,704 of taxable income. See *Individual Income Tax Year Changes*. Missouri Department of Revenue. [dor.mo.gov/taxation/individual/tax-types/income/year-changes] Accessed on Jul. 8, 2022.

84. *Pass Through Entity Resources*. Missouri Society of Certified Public Accountants. [mocpa.org/access-resources/interest-areas/tax/pass-through-entity-taxes-resources] Accessed on Jul. 8, 2022.

85. IL Pub. 129, *Pass-through Entity Information*.

For Example 2

671121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120-S) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
61-5546557

B Corporation's name, address, city, state, and ZIP code
Ess Korp
18 Nothing St.
Nowheresville, IL 61002

C IRS Center where corporation filed return
Kansas City, MO 64999-0013

D Corporation's total number of shares
Beginning of tax year 100
End of tax year 100

Part II Information About the Shareholder

E Shareholder's identifying number
615-54-6556

F Shareholder's name, address, city, state, and ZIP code
Chris Chin
423 Sideways Ln.
Somewheresville, IL 60022-8423

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

1	Ordinary business income (loss) (6,450)	13	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	14	Schedule K-3 is attached if checked . . . . ▶ ☐
6	Royalties	15	Alternative minimum tax (AMT) items
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss) 100,000		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)	16	Items affecting shareholder basis
10	Other income (loss)		

The following chart shows how the amounts reported on Chris' **IL Schedule K-1-P** affected their 2021 Form IL-1040, *Individual Income Tax Return.* Excerpts from their 2021 Form IL-1040 and IL Schedule K-1-P follow. The **PTE tax credit was claimed on line 28** in Step 8 on page 2 of their Form IL-1040.

		Form IL K-1-P	Form IL-1040
Federal AGI	$ 93,550		Line 1
State taxes	6,450	Line 33	Line 3 Other additions (Schedule M)
Illinois base income	100,000		Line 9
Exemption allowance	(2,375)		Line 10
Net income	97,625		Line 11
Illinois tax (4.95%)	4,832		Line 12
PTE credit	4,950	Line 53a	Line 28

Note. For cash basis taxpayers, the adjustment shown on line 33, page 2 of the Schedule K-1-P does not usually equal the entity's state corporate tax liability for the year.

For Example 2

Illinois Department of Revenue
2021 Form IL-1040
Individual Income Tax Return

or for fiscal year ending __ __/__ __

Over 80% of taxpayers file electronically. It is easy and you will get your refund faster. Visit tax.illinois.gov.

Step 1: Personal Information Enter personal information and Social Security numbers (SSN). You must provide the entire SSN(s) - no partial SSN.

A Your first name and middle initial	Your last name	Year of birth	Your social security number
Chris	Chin	1965	615-54-6556
Spouse's first name and middle intial	Spouse's last name	Spouse's year of birth	Spouse's social security number

Mailing address (See inst. if foreign address)	Apartment number	City	State	Zip or postal code
423 Sideways Ln.		Somewheresville	IL	60022-8423
Foreign nation if not US (do not abbreviate)	County (Illinois only)	Email address		
	Nerf			

B Filing status: ☒ Single ☐ Married filing jointly ☐ Married filing separately ☐ Widowed ☐ Head of household

C **Check** If someone can claim you, or your spouse if filing jointly, as a dependent. See instructions. ☐ You ☐ Spouse

D **Check** the box if this applies to you during 2021: ☐ Nonresident - **Attach** Sch. NR ☐ Part-year resident - **Attach** Sch. NR

(Whole dollars only)

Step 2: Income

1	Federal adjusted gross income from your federal Form 1040 or 1040-SR, Line 11.	1	93,550 .00
2	Federally tax-exempt interest and dividend income from your federal Form 1040 or 1040-SR, Line 2a.	2	.00
3	Other additions. **Attach** Schedule M.	3	6,450 .00
4	**Total income**. Add Lines 1 through 3.	4	100,000 .00

Staple W-2 and 1099 forms here

Step 3: Base Income

5	Social Security benefits and certain retirement plan income received if included in Line 1. **Attach** Page 1 of federal return.	5	.00		
6	Illinois Income Tax overpayment included in federal Form 1040 or 1040-SR, Schedule 1, Ln. 1.	6	.00		
7	Other subtractions. **Attach** Schedule M. Check if Line 7 includes any amount from Schedule 1299-C. ☐	7	.00		
8	Add Lines 5, 6, and 7. This is the total of your subtractions.			8	.00
9	**Illinois base income**. Subtract Line 8 from Line 4.			9	100,000 .00

Step 4: Exemptions

10	a Enter the exemption amount for yourself and your spouse. **See instructions.**	a	2,375 .00		
	b **Check** if 65 or older: ☐ You + ☐ Spouse **# of checkboxes X** $1,000 =	b	.00		
	c **Check** if legally blind: ☐ You + ☐ Spouse **# of checkboxes X** $1,000 =	c	.00		
	d If you are claiming dependents, enter the amount from Schedule IL-E/EIC, Step 2, Line 1. **Attach** Schedule IL-E/EIC.	d	.00		
	Exemption allowance. Add Lines 10a through 10d.			10	2,375 .00

Step 5: Net Income and Tax

11	***Residents:*** **Net income**. Subtract Line 10 from Line 9. ***Nonresidents and part-year residents:*** Enter the **Illinois net income** from Schedule NR. **Attach** Schedule NR.	11	97,625 .00
12	***Residents:*** Multiply Line 11 by 4.95% (.0495). Cannot be less than zero. ***Nonresidents and part-year residents:*** Enter the tax from Schedule NR.	12	4,832 .00
13	Recapture of investment tax credits. **Attach** Schedule 4255.	13	.00
14	**Income tax.** Add Lines 12 and 13. Cannot be less than zero.	14	4,832 .00

Staple your check and IL-1040-V

Step 6: Tax After Nonrefundable Credits

15	Income tax paid to another state while an Illinois resident. **Attach** Schedule CR.	15	.00		
16	Property tax and K-12 education expense credit amount from Schedule ICR. **Attach** Schedule ICR.	16	.00		
17	Credit amount from Schedule 1299-C. **Attach** Schedule 1299-C.	17	.00		
18	Add Lines 15, 16, and 17. This is the total of your credits. Cannot exceed the tax amount on Line 14.			18	.00
19	**Tax after nonrefundable credits.** Subtract Line 18 from Line 14.			19	4,832 .00

Step 7: Other Taxes

20	Household employment tax. See instructions.	20	.00
21	Use tax on internet, mail order, or other out-of-state purchases from UT Worksheet or UT Table in the instructions. **Do not** leave blank.	21	.00
22	Compassionate Use of Medical Cannabis Program Act and sale of assets by gaming licensee surcharges.	22	.00
23	**Total Tax**. Add Lines 19, 20, 21, and 22.	23	4,832 .00

IL-1040 Front (R-12/21)
Printed by authority of the State of Illinois - web only, 1.

This form is authorized as outlined under the Illinois Income Tax Act. Disclosure of this information is required. Failure to provide information could result in a penalty.

For Example 2

24	Total tax from Page 1, Line 23.		24	4,832 .00
Step 8: Payments and Refundable Credit				
25	Illinois Income Tax withheld. **Attach** Schedule IL-WIT.	25 .00		
26	Estimated payments from Forms IL-1040-ES and IL-505-I, including any overpayment applied from a prior year return.	26 .00		
27	Pass-through withholding. **Attach** Schedule K-1-P or K-1-T.	27 .00		
28	Pass-through entity tax credit. **Attach** Schedule K-1-P or K-1-T.	28 4,950 .00		
29	Earned Income Credit from Schedule IL-E/EIC, Step 4, Line 8. **Attach** Schedule IL-E/EIC.	29 .00		
30	**Total payments and refundable credit**. Add Lines 25 through 29.		30	4,950 .00
Step 9: Total				
31	If Line 30 is greater than Line 24, subtract Line 24 from Line 30.		31	118 .00
32	If Line 24 is greater than Line 30, subtract Line 30 from Line 24.		32	.00

Step 10: Underpayment of Estimated Tax Penalty and Donations - Only complete Step 10 for late-payment penalty for underpayment of estimated tax or to make a voluntary charitable donation.

33	Late-payment penalty for underpayment of estimated tax.	33 .00		
	a ☐ Check if at least two-thirds of your federal gross income is from farming.			
	b ☐ Check if you or your spouse are 65 or older and permanently living in a nursing home.			
	c ☐ Check if your income was not received evenly during the year and you annualized your income on Form IL-2210. **Attach** Form IL-2210.			
	d ☐ Check if you were not required to file an Illinois Individual Income Tax return in the previous tax year.			
34	Voluntary charitable donations. **Attach** Schedule G.	34 .00		
35	**Total penalty and donations**. Add Lines 33 and 34.		35	.00
Step 11: Refund				
36	If you have an amount on Line 31 and this amount is greater than Line 35, subtract Line 35 from Line 31. This is your **overpayment**.		36	118.00
37	Amount from Line 36 you want **refunded to you**. Check **one** box on Line 38. See instructions.		37	118.00

... receive my refund by

Enter identification number from Line 7.

Step 5: Figure your partner's or shareholder's share of Illinois additions and subtractions

K-1-P Recipient: Before using the information provided in Step 5, you must read Schedule K-1-P(2) to correctly report the amounts listed in Columns A and B.

Additions		A Member's share from Form IL-1065 or IL-1120-ST	B Member's share apportioned or allocated to Illinois
32 Federally tax-exempt interest income	32		
33 Illinois taxes and surcharge deducted. See Instructions.	33	6,450	6,450
34 Illinois Special Depreciation addition	34		

Step 7: Figure your partner's or shareholder's share of your Illinois credits, recapture, pass-through withholding, pass-through entity tax credit, and federal income subject to surcharge

52 Illinois Income Tax Credits	Credit Code		Member's share from Illinois tax return	53 Other credits		Member's share from Illinois tax return
a Film Production Services	5000	52a		a Pass-through Entity Tax Credit See instructions.	53a	4,950
b Enterprise Zone Investment	5080	52b				
... Construction ...	5120	...		b ...		

SCHEDULE K-1

TERMINOLOGY AND PRESENTATION

This section of the chapter uses the following terms.

- **Schedule K-1 recipient** — identifies a person who receives a Schedule K-1 from a partnership, an S corporation, a trust, or an estate.
- **Partner** — identifies a Schedule K-1 recipient who receives their Schedule K-1 from an entity taxed as a partnership. This might be a partnership or a multi-member LLC that has not filed a form with the IRS to be treated as an association or a corporation.
- **Shareholder** — identifies a natural person owning shares in a corporation or association that has elected to be treated as an S corporation.
- **Beneficiary** — identifies a person who receives a Schedule K-1 (Form 1041) from a trust or an estate.
- **Investor** — denotes an individual who does not have material or active participation in either a partnership, an LLC, or an S corporation.

At the beginning of each common item discussed, there is a summary list indicating the box number on each form's Schedule K-1 that should be used. Here is an example.

Schedule K-1 for...	Uses Box...
Form 1065	1
Form 1120-S	1
Form 1041	6

INTRODUCTION

Schedule K-1 is the tool designed by the IRS for communicating tax information from PTEs to partners, shareholders, and beneficiaries. Varieties of the schedule exist to match the uniqueness of each type of entity.

- Partnership, Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*
- S corporations, Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credit, etc.*
- Trusts and estates, Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credit, etc.*

> **Note.** Partnerships filing a Form 8865, *Return of U.S. Persons with Respect to Certain Foreign Partnerships,* also have an associated Schedule K-1 to file, Schedule K-1 (Form 8865), *Partner's Share of Income, Deductions, Credits, etc.* Because the boxes on Schedule K-1 (Form 8865) are the same as on Schedule K-1 (Form 1065), these materials do not cover those boxes separately beyond what is discussed for Schedule K-1 (Form 1065).

Blank examples of each form can be found in the appendix at the end of the chapter.

Before exploring the Schedules K-1, it is important to determine whether the recipient is an active or passive participant within the entity. This has a direct impact on how reported gains or losses are treated on the individual's tax return. Specifics are discussed for each entity later in this section.

EXPLORING SCHEDULE K-1

A Schedule K-1 reflects the recipient's share of all the income, deductions, credits, distributions, and all other activities required to be considered on their individual income tax return. This material compares how different Schedules K-1 present various common items and the tax consequences of unique items.

Ordinary Business Income and Loss

Schedule K-1 for...	Uses Box...
Form 1065	1
Form 1120-S	1
Form 1041	6

Ordinary income is the bottom-line result of the business's fundamental reason for existing. If the business uses the entity's resources efficiently, the ordinary business income is positive, and the partners/shareholders get a proportionate share of the profits. If the entity loses money instead, the business reports losses to the partners/shareholders on Schedules K-1.

Income reported on Schedule K-1 flows to Schedule E, *Supplemental Income and Loss*, line 28, if the Schedule K-1 recipient **materially participated** in the entity. If the Schedule K-1 recipient did not materially participate in the entity's business, the ordinary income amount is only reported on Schedule E if it represents positive income.[86]

However, if the Schedule K-1 recipient did not materially participate in the business and the ordinary business income amount represents a loss, Schedule E is not immediately involved. At-risk rules may impose additional limitations on ordinary income losses that Schedule K-1 recipients can report on their income tax returns. These rules are discussed later. The ordinary business income and loss is reported on Form 8582, *Passive Activity Loss Limitations*. Some portion of the loss may be reported on Schedule E, depending on the determination of allowed losses.

For beneficiaries of trusts or estates receiving Schedule K-1 (Form 1041), items most closely corresponding to ordinary income are reported in box 6, ordinary business income.

> **Note.** For additional information about Schedule E, see the 2020 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Schedule E. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Net Rental Real Estate Income and Loss

Schedule K-1 for...	Uses Box...
Form 1065	2
Form 1120-S	2
Form 1041	7

Net rental real estate income is generally passive, but if the Schedule K-1 recipient meets all the qualifications for a real estate professional, the amount may not be passive income. Real estate professionals must report net income or loss from real estate activities in which they materially participated. This amount appears on page 2 of Schedule E in part V, line 43. Special rules apply for publicly traded partnerships (PTP) which is beyond the scope of these materials.

86. Instructions for Schedule E; Instructions for Form 8582.

If the recipient is not a real estate professional, any positive income is passive income and reported on Schedule E.

> **Note.** Some passive investors may still report net rental real estate losses, depending on their marital status and MAGI.[87] For more information, see the 2019 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Selected Real Estate Topics. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

For beneficiaries, net rental real estate income or loss is reported in box 7 on Schedule K-1. The exception allowing up to $25,000 of passive rental real estate losses to be recognized by certain persons is not available to trusts or estates because it is specifically restricted to natural persons.[88]

Other Rental Income

Schedule K-1 for...	Uses Box...
Form 1065	3
Form 1120-S	3
Form 1041	8

If a partnership or S corporation rents property other than real estate, the entity reports income or loss on Schedule K-1. The Code provides that this income is always passive.[89] Income reported as other rental income on Schedule K-1 flows to Schedule E, line 28, column (h). If other rental income is a loss, calculations on Form 8582 determine what portion of the loss, if any, is reported on Schedule E, line 28, column (g).

Guaranteed Payments

Schedule K-1 for...	Uses Box...
Form 1065	4
Form 1120-S	Not applicable
Form 1041	Not applicable

Recent years have brought an increased emphasis on reporting guaranteed payments on Schedule K-1 (Form 1065). The 2021 version of Schedule K-1 requires guaranteed payments for **services** to be separated from guaranteed payments for **capital.** This income generally is reported on an individual partner's Schedule E on line 28 in column (k), as it represents nonpassive income.

Although a partnership pays these funds to a partner, they reduce the partnership's taxable income and produce taxable income for the partner. It treats these payments as though they were made to persons not related to the partnership, even though they are.[90]

Schedule K-1 (Form 1120-S) does not have an equivalent box because S corporations do not have guaranteed payments.

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87. IRC §469(i)(1).

88. Ibid.

89. IRC §469(c)(2).

90. IRC §707(c).

Guaranteed Payments for Services — Box 4a. Guaranteed payments for a partner's services are determined independently of the partnership's income. Because of this, they are suggestive of a partner's self-employment (SE) earnings, a topic discussed later in conjunction with box 14. Health insurance premiums that the partnership has paid should be included in this amount.

Guaranteed Payments for Capital — Box 4b. These payments are for the use of a partner's capital. One common use is to compensate a retiring partner for their share of the partnership's unpaid receivables or goodwill.[91]

Total Guaranteed Payments — Box 4c. This box contains the sum of guaranteed payments for services and guaranteed payments for capital.

Interest Income

Schedule K-1 for...	Uses Box...
Form 1065	5
Form 1120-S	4
Form 1041	1

Interest income received by the PTE is reported in this box. This income flows to the individual's Schedule B, *Interest and Ordinary Dividends*. Foreign source interest income may be reported on Schedule K-3 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc. — International* or Schedule K-3 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc. — International*.

> **Note.** For more information on Schedule K-3 reporting, see the 2022 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

Tax-exempt interest income is not reported in this box. Instead, partnerships report it in box 18, as discussed later. S corporations report it in box 16 with other items affecting shareholder basis. Trusts and estates report tax-exempt income in box 14 with code A.

Dividends

Schedule K-1 for...	Uses Boxes...
Form 1065	6a and 6b
Form 1120-S	5a and 5b
Form 1041	2a and 2b

Dividend income received by a PTE is reported in these boxes. The recipient reports it on their Schedule B. It is separated into ordinary dividends and qualified dividends, so that qualified dividends can be taxed at a capital gain rate.[92]

---

91. IRC §736(a)(2), as cited in 2021 Partner's Instructions for Schedule K-1 (Form 1065).

92. IRC §1(h)(11(A).

Royalties

Schedule K-1 for...	Uses Box...
Form 1065	7
Form 1120-S	6
Form 1041	Not applicable

Royalty income may result from ownership of intangible property, such as copyrights or patents. It may also be the income produced by a depletable resource, such as crude oil or natural gas.

A separate box for reporting royalty income does not exist on Schedule K-1 (Form 1041). Instead, the amount is reported in the income with other portfolio and nonbusiness income in box 5.[93]

Net Short-Term Capital Gain

Schedule K-1 for...	Uses Box...
Form 1065	8
Form 1120-S	7
Form 1041	3

Short-term capital gain income and losses are netted together to produce the amount shown in this box. It flows to the recipient's Schedule D, *Capital Gains and Losses,* line 5.

Net Long-Term Capital Gain

Schedule K-1 for...	Uses Box...
Form 1065	9a
Form 1120-S	8a
Form 1041	4a

Net long-term capital gains are reported in this box after being netted together. This amount flows to the recipient's Schedule D, line 12.

Collectibles (28%) Gain and Loss

Schedule K-1 for...	Uses Box...
Form 1065	9b
Form 1120-S	8b
Form 1041	4b

Gain or loss from the sale of collectibles held longer than one year is reported in this box. Collectibles include works of art, any stamp or coin, or bullion.[94] However, this box may include the unrealized appreciation of the interest of a departing partner on their final Schedule K-1.

93. Instructions for Schedule K-1 (Form 1041).

94. IRC §§1(h)(4) and (5), cross-referencing §408(m), but disregarding §408(m)(3).

Unrecaptured IRC §1250 Gain

Schedule K-1 for...	Uses Box...
Form 1065	9c
Form 1120-S	8c
Form 1041	4c

Unrecaptured §1250 gain is reported in this box, which indirectly flows through to Schedule D. The amount first is taken on the Unrecaptured Section 1250 Gain Worksheet — Line 19. The amount is entered in different locations on this worksheet, depending on its origin.

- Sale or exchange of an interest in the entity, either a partnership or an S corporation — the amount is recorded on line 5 of the Unrecaptured Section 1250 Gain Worksheet
- Disposal of an interest in a partnership or S corporation — the amount is recorded on line 10 of the Unrecaptured Section 1250 Gain Worksheet
- Flow through from an estate, a trust, a regulated investment company, or a real estate investment trust (REIT) — the amount is recorded on line 11 of the Unrecaptured Section 1250 Gain worksheet

The Unrecaptured Section 1250 Gain Worksheet — Line 19 follows.

Unrecaptured Section 1250 Gain Worksheet—Line 19

Keep for Your Records

If you aren't reporting a gain on Form 4797, line 7, skip lines 1 through 9 and go to line 10.

1.	If you have a section 1250 property in Part III of Form 4797 for which you made an entry in Part I of Form 4797 (but not on Form 6252), enter the **smaller** of line 22 or line 24 of Form 4797 for that property. If you didn't have any such property, go to line 4. If you had more than one such property, see instructions		**1.**
2.	Enter the amount from Form 4797, line 26g, for the property for which you made an entry on line 1		**2.**
3.	Subtract line 2 from line 1		**3.**
4.	Enter the total unrecaptured section 1250 gain included on line 26 or line 37 of Form(s) 6252 from installment sales of trade or business property held more than 1 year. See instructions		**4.**
5.	Enter the total of any amounts reported to you on a Schedule K-1 from a partnership or an S corporation as "unrecaptured section 1250 gain"		**5.**
6.	Add lines 3 through 5		**6.**
7.	Enter the **smaller** of line 6 or the gain from Form 4797, line 7	**7.**	
8.	Enter the amount, if any, from Form 4797, line 8	**8.**	
9.	Subtract line 8 from line 7. If zero or less, enter -0-		**9.**
10.	Enter the amount of any gain from the sale or exchange of an interest in a partnership attributable to unrecaptured section 1250 gain. See instructions		**10.**
11.	Enter the total of any amounts reported to you as "unrecaptured section 1250 gain" on a Schedule K-1, Form 1099-DIV, or Form 2439 from an estate, trust, real estate investment trust, or mutual fund (or other regulated investment company) or in connection with a Form 1099-R		**11.**
12.	Enter the total of any unrecaptured section 1250 gain from sales (including installment sales) or other dispositions of section 1250 property held more than 1 year for which you didn't make an entry in Part I of Form 4797 for the year of sale. See instructions		**12.**
13.	Add lines 9 through 12		**13.**
14.	If you had any section 1202 gain or collectibles gain or (loss), enter the total of lines 1 through 4 of the **28% Rate Gain Worksheet**. Otherwise, enter -0-	**14.**	
15.	Enter the (loss), if any, from Schedule D, line 7. If Schedule D, line 7, is zero or a gain, enter -0-	**15.** ( )	
16.	Enter your long-term capital loss carryovers from Schedule D, line 14, and Schedule K-1 (Form 1041), box 11, code D*	**16.** ( )	
17.	Combine lines 14 through 16. If the result is a (loss), enter it as a positive amount. If the result is zero or a gain, enter -0-		**17.**
18.	**Unrecaptured section 1250 gain.** Subtract line 17 from line 13. If zero or less, enter -0-. If more than zero, enter the result here and on Schedule D, line 19		**18.**

* If you are filing Form 2555 (relating to foreign earned income), see the footnote in the Foreign Earned Income Tax Worksheet in the Instructions for Forms 1040 and 1040-SR before completing this line.

IRC §1231 Gain

Schedule K-1 for...	Uses Box...
Form 1065	10
Form 1120-S	9
Form 1041	Not applicable

Unless the Schedule K-1 recipient is a real estate professional, the amount appearing in this box generally represents passive income. It flows to their Form 4797, *Sales of Business Property*, line 2 if it represents a gain on any activity or a loss on an activity that is **not a passive activity**. A loss from a passive activity flows to the recipient's Form 8582.

The reporting of this income may be affected by any nonrecaptured §1231 losses incurred by the recipient over the last five years.[95] Although §1231 gains are generally treated as long-term capital gains, this provision specifies that they are treated as **ordinary income** to the extent they do not exceed net §1231 **losses** during that period of time.

> **Note**. For more information on §§1231 and 1250 gains and losses, see the section on Form 4797 Basics in the 2022 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Small Business Issues.

Other Income

Schedule K-1 for...	Uses Box...
Form 1065	11
Form 1120-S	10
Form 1041	Not applicable

Schedules K-1 for both partnerships and S corporations provide a box for reporting other sources of income that do not fit one of the categories previously provided. The instructions for Schedule K-1 (Form 1065) provide eight codes for identifying specific types of income, plus another code if none of the others fit. The instructions for Schedule K-1 (Form 1120-S) provide seven codes, plus one for miscellaneous income. Four of the less commonly used codes are discussed next.[96]

Code B: Involuntary Conversions. A partnership or an S corporation may report a gain or loss associated with either casualty losses or theft. Assuming these amounts are associated with an active trade or business, they flow to Form 4684, *Casualties and Thefts*, section B. Although the use of the property has been lost, either a gain or loss may result. The entity may provide a separate statement providing the information needed to prepare Form 4684. This code is also used by S corporations to report involuntary conversions in box 10 of Schedule K-1 (Form 1120-S).

Code E: Cancellation of Debt. It is not uncommon for partnerships or S corporations to be beneficiaries of canceled debts. Generally, some portion of this flows through to the Schedule K-1 recipient's individual income tax returns as gross income. IRC §108(b) provides for tax attributes to be reduced in some cases. Taxpayers may be able to use this approach to avoid recognizing the cancellation of debt income by reducing net operating losses, capital loss carryovers, or, more commonly, basis. Because special rules for S corporations require that the cancellation of debt income be recognized at the corporate level,[97] no code is needed for Schedule K-1 (Form 1120-S).

95. IRC §1231(c)(2).
96. Partner's Instructions for Schedule K-1 (Form 1065).
97. IRC §108(d)(7)(A).

Code H: IRC §951(a) Income Inclusions.[98] Partnerships organized in the United States may be shareholders of foreign corporations. Some of the entity's income may be passed through to partners as §951(a) income inclusions with this code. This assumes that the partnership does not rely on a proposed regulation that allows it to treat it as not owning the stock of the foreign corporation.[99] Code E associated with box 10 on Schedule K-1 (Form 1120-S) serves the same purpose.

Code I: Other Income (Loss). Items reported in this box with code I require a special explanation from the partnership or S corporation. These items may include gain or loss from the disposition of an interest in property producing oil or gas, as well as geothermal property or other mineral property. This code is also used to report capital gains and losses on property not classified as portfolio income on Schedule D. This same purpose is served by code H on Schedule K-1 (Form1120-S).

IRC §179 Deductions

Schedule K-1 for...	Uses Box...
Form 1065	12
Form 1120-S	11
Form 1041	Not applicable

One of the most common separately stated items is §179 expense deduction. The partnership or S corporation does not take this into account in its ordinary business income but instead passes it through to the partner or shareholder on Schedule K-1. IRC §179 deduction information has earned its own box on Schedule K-1 for partnerships, specifically box 12. Similarly, S corporations report a shareholder's share of §179 deductions in box 11.

The §179 deduction at the partnership or S corporation level is reported in part I of Form 4562, *Depreciation and Amortization*. The business income limitation on line 11 is line 22 from Form 1065, *U.S. Return of Partnership Income*, **plus guaranteed payments made to partners.** In the same way, the business income on line 11 for an S corporation is ordinary business income from line 21 of Form 1120-S, *U.S. Income Tax Return for an S Corporation*, plus compensation paid to the firm's shareholder-employees.

The effect of §179 deductions on SE earnings is discussed later.

98. IRC §951(a).

99. Prop. Treas. Reg. §1.958-1(d).

Example 3. Joe and Herb form Metal Benders, LLC, an LLC formed in the United States. Joe has a 60% interest in the partnership, while Herb has a 40% interest. In 2021, Metal Benders had gross revenue of $1 million and incurred the following expenses.

Guaranteed payments to partners	$ 180,000
Interest	10,000
Accounting and tax preparation	10,000
Insurance	10,000
Office expense	80,000
Outside services	880,000
Total expense	$1,170,000

In addition, Metal Benders purchased a lathe for $15,000, which qualified for the §179 expense deduction.

Metal Benders reports an ordinary loss of $170,000 ($1 million revenue – $1,170,000 expenses) on line 22 of Form 1065. However, for §179 purposes, the guaranteed payments to Joe and Herb are added back, resulting in line 11 on Form 4562 showing a **positive** $10,000 amount ($180,000 guaranteed payments + ($170,000) loss). Because the guaranteed payments to partners are added back to ordinary business income, a §179 expense deduction is still passed through to Joe and Herb, even though it is reduced from the full $15,000 cost of the lathe to $10,000 (limited to the company's ordinary business income without the deduction for guaranteed payments (($170,000) ordinary business loss + $180,000 guaranteed payments.))

Consequently, Joe receives a Schedule K-1 (Form 1065) showing a $6,000 §179 deduction ($10,000 × 60% ownership) in box 12, and Herb receives a Schedule K-1 showing the remaining $4,000. The balance of the $5,000 §179 expense deduction is carried forward to 2022. Form 4562, part I, for Metal Benders, LLC, is shown next, followed by Joe's Schedule K-1 (Form 1065).

Form **4562** — Department of the Treasury, Internal Revenue Service (99)

Depreciation and Amortization
(Including Information on Listed Property)
▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form4562* for instructions and the latest information.

OMB No. 1545-0172 — **2021** — Attachment Sequence No. **179**

Name(s) shown on return	Business or activity to which this form relates	Identifying number
Metal Benders, LLC	Form 1065	99-8888888

Part I — Election To Expense Certain Property Under Section 179
Note: If you have any listed property, complete Part V before you complete Part I.

1	Maximum amount (see instructions)	1	1,050,000
2	Total cost of section 179 property placed in service (see instructions)	2	15,000
3	Threshold cost of section 179 property before reduction in limitation (see instructions)	3	2,620,000
4	Reduction in limitation. Subtract line 3 from line 2. If zero or less, enter -0-	4	0
5	Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter -0-. If married filing separately, see instructions	5	1,050,000

6 (a) Description of property	(b) Cost (business use only)	(c) Elected cost
Lathe	15,000	15,000
7 Listed property. Enter the amount from line 29	7	0

8	Total elected cost of section 179 property. Add amounts in column (c), lines 6 and 7	8	15,000
9	Tentative deduction. Enter the **smaller** of line 5 or line 8	9	15,000
10	Carryover of disallowed deduction from line 13 of your 2020 Form 4562	10	0
11	Business income limitation. Enter the smaller of business income (not less than zero) or line 5. See instructions	11	10,000
12	Section 179 expense deduction. Add lines 9 and 10, but don't enter more than line 11	12	10,000
13	Carryover of disallowed deduction to 2022. Add lines 9 and 10, less line 12 ▶ 13: 5,000		

Note: Don't use Part II or Part III below for listed property. Instead, use Part V.

Special Depreciation Allowance and Other Depreciation (Don't include listed property. See instructions.)

For Example 3

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year beginning / / 2021 ending / /

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
99-8888888

B Partnership's name, address, city, state, and ZIP code
Metal Benders, LLC
1200 West Bartlett Rd
Elgin, IL 60120

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 SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
444-55-6666

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Joe Blacksmith
456 Anvil Dr
Elgin, IL 60120

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

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? ______

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ► ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	60 %
Loss	60 %	60 %
Capital	60 %	60 %

Check if decrease is due to sale or exchange of partnership interest . ► ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$	$
Qualified nonrecourse financing . . .	$	$
Recourse . . .	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ► ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 300,000
Capital contributed during the year . .	$
Current year net income (loss)	$
Other increase (decrease) (attach explanation)	$ (108,000)
Withdrawals and distributions . . .	$ ( )
Ending capital account	$ 192,000

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

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

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

1	Ordinary business income (loss)	(102,000)
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4a	Guaranteed payments for services	108,000
4b	Guaranteed payments for capital	
4c	Total guaranteed payments	108,000
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
6c	Dividend equivalents	
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)	
11	Other income (loss)	
12	Section 179 deduction	6,000
13	Other deductions	
14	Self-employment earnings (loss)	A 6,000
15	Credits	
16	Schedule K-3 is attached if checked . . . . ► ☐	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	C
19	Distributions	
20	Other information	N 6,000
21	Foreign taxes paid or accrued	

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

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For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

Other Deductions

Schedule K-1 for...	Uses Box...
Form 1065	13
Form 1120-S	12
Form 1041	Not applicable

Many types of expenses must be separately stated, and generally, this involves the 'Other Deductions' box. In 2021, partnerships have 20 separately stated codes and S corporations have 14. Partnerships must allocate these deductions according to the terms of their operating agreements. S corporations must allocate these deductions to shareholders according to their ownership of the S corporation's shares of stock.

Taxpayers may see any of the following noteworthy codes in the Other Deductions box on their Schedule K-1.

Code A: Cash Contributions (60%). Partnerships or S corporations may make tax-deductible cash contributions, but these contributions must be passed through to partners or shareholders. Taxpayers report these expenses on their Schedule A, *Itemized Deductions,* assuming they itemize their deductions. If the partner or shareholder did not itemize their deductions for 2021, the amount reported with this code could be reported on Form 1040, *U.S. Individual Income Tax Return,* line 12b, but subject to the limit of $600 for taxpayers using MFJ filing status or $300 for taxpayers using other filing statuses.[100]

Code L: Deductions — Portfolio Income (Other). These items are generally reported on Schedule A, line 16. This code can be used to allocate investment expense to partners or shareholders, which may be deductible on their Schedules A.

Code V: IRC §743(b) Negative Adjustments. Partnerships use code V to report negative basis adjustments after the death of a partner or transfer of an interest in partnerships. The partnership must have filed an election under IRC §754 to make this adjustment and report with code V. The presence of code F in box 11 represents a positive §743(b) adjustment.

Code W: Other Deductions. This code is available for deductions that should be reported on an individual's Schedule A if they itemize. It may also be used for the following purposes.[101]

- Deduction of costs to remove traffic or architectural barriers that may inhibit the movement of disabled or elderly citizens.
- Interest paid on certain investment items, including the financing of a working interest in property producing oil or natural gas.
- Interest paid in association with distributions from the partnership that were funded with borrowed money.[102] This provides an exception to the disguised sale of property regulations.[103]

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100. IRC §170(p).

101. 2021 Partner's Instructions for Schedule K-1 (Form 1065).

102. Treas. Reg. §1.707-5(b)(1).

103. IRC §707(a)(2).

Directly Apportioned Deductions[104]

Schedule K-1 for...	Uses Box...
Form 1065	Not applicable
Form 1120-S	Not applicable
Form 1041	9

Beneficiaries of trusts or estates may receive a Schedule K-1 with an amount in box 9, which represents a deduction for depreciation, depletion, or amortization that is allocated to them. The deduction relates to income reported in boxes 5, 6, 7, or 8 of the Schedule K-1. A statement should be attached to the form specifying the activity to which it relates.

SE Earnings

Schedule K-1 for...	Uses Box...
Form 1065	14
Form 1120-S	Not applicable
Form 1041	Not applicable

Partners actively working in their partnerships may generate SE earnings that flow to their Schedule SE, *Self-Employment Tax.* This reflects the income they received for their services. This is generally the amount of guaranteed payments for services adjusted for ordinary business income reported to a general partner. Because SE issues are not a consideration for S corporation shareholders or beneficiaries of trusts or estates, this box has no equivalent on either Schedule K-1 for S corporations or fiduciary entities.

The amount actually reported on Schedule SE is reduced for any §179 expense deduction allocated to the partner on Schedule K-1, box 12.

> **Example 4.** Use the same facts as **Example 3.** Joe's Schedule K-1 (Form 1065) reports box 14 SE earnings of \$6,000 (\$108,000 Joe's guaranteed payment – \$102,000 Joe's share of ordinary income). SE earnings are further reduced to \$0 by Joe's \$6,000 share of the \$10,000 §179 expense deduction. As a result, Joe has no SE tax for 2021 and does not need to file Schedule SE.

SE issues arising from Schedule K-1 (Form 1065), including the impact of §179 deductions, are discussed in greater detail later.

The following are several relevant codes for SE earnings.

Code A: Net Earnings (Loss) From SE activities. This amount is generally guaranteed payments to the recipient, but if they are also a general partner or this is not a passive activity for the partner, the guaranteed payment should be adjusted by the partner's share of the business gain or loss. Certain employee benefits should be included in this amount, including the partner's share of any health insurance payments the partnership makes on their behalf.[105]

Code B: Gross Farming or Fishing Income. An individual working for a partnership engaged in farming or fishing may receive a Schedule K-1 with an amount reported using code B. This amount is reported in the summary section of their Schedule E on page 2, although it may be adjusted as described earlier.

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104. Instructions for Schedule K-1 (Form 1041).

105. IRC §162(l).

Code C: Gross Nonfarm Income. Code C allows a partner to compute SE tax using the nonfarm optional method.[106]

Credits

Schedule K-1 for...	Uses Box...
Form 1065	15
Form 1120-S	13
Form 1041	13

A PTE's activities may qualify it for a credit, but because the entity itself does not pay income tax, the information about credits must be passed to the individual. The credits may be subject to limits imposed at either the entity level or at the individual level.

The following are some noteworthy codes used in the Credits box.

Code J: Work Opportunity Credit (WOC). This code designates amounts that can be taken as a credit on Form 5884, *Work Opportunity Credit,* or on Form 3800, *General Business Credit.* Form 3800 is used by partners who are not other partnerships or S corporations. If the credit is associated with a passive activity for an individual, they are required to complete Form 8582-CR, *Passive Activity Credit Limitations,* as well. The WOC is a nonrefundable general business credit that is extended through 2025.[107] Employers receive credit for hiring persons from targeted groups that are traditionally underrepresented. The credit is a percentage of wages paid to employees who meet specific employment requirements. The credit is equal to 40% of qualified wages if the individual works more than 400 hours. It is equal to 25% of qualified wages if the individual works a minimum of 120 hours. Qualified wages are limited to $6,000 in the employee's first year of employment unless the individual is a qualified veteran. For a qualified veteran, up to $12,000 of wages are considered for the credit.

Example 5. Use the same facts as **Example 3,** except that Metal Benders also hired an intern named Peter in April 2021. Peter is an ex-felon (a targeted group for the WOC) and worked in the shop for 425 hours during 2021. Peter's Form W-2, *Wages and Tax Statement*, showed he earned $6,162 for the year, just over the $6,000 cap on WOC earnings. Metal Benders is entitled to a credit of $2,400 ($6,000 wage cap × 40%), which appears on the Schedules K-1 that Joe and Herb receive in Box 15 with code J. Joe's share of this amount is $1,440 ($2,400 × 60%) while Herb's is the balance of $960. These amounts also appear in Joe's and Herb's Schedule K-1 (Form 1065), box 18, code C, because the wages for which the credit is taken are a nondeductible expense. With the assumption that the amount paid for outside services is reduced for Peter's wages, the Schedule K-1 (Form 1065) for Joe follows. For illustration purposes, this example ignores federal and state payroll taxes.

The following differences are noted from **Example 3.**

- Joe has a slightly smaller ordinary business loss in box 1. His loss is reduced by the nondeductible portion of Peter's wages.
- Joe has a larger §179 expense deduction for the lathe that was purchased.
- Joe's SE earnings increased by his share of the nondeductible WOC credit.
- Joe's share of the LLC's capital is reduced by his share of the WOC.

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106. IRC §1402(a).

107. IRC §51*; Consolidated Appropriations Act of 2021,* PL 116-260, §113(a), Div. EE.

For Example 5

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

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
99-8888888

B Partnership's name, address, city, state, and ZIP code
Metal Benders, LLC
1200 West Bartlett Rd
Elgin, IL 60120

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 SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
444-55-6666

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Joe Blacksmith
456 Anvil Dr
Elgin, IL 60120

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

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? ______

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ► ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	60 %
Loss	60 %	60 %
Capital	60 %	60 %

Check if decrease is due to sale or exchange of partnership interest . ► ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$	$
Qualified nonrecourse financing	$	$
Recourse	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ► ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 300,000
Capital contributed during the year . .	$
Current year net income (loss)	$
Other increase (decrease) (attach explanation)	$ (109,440)
Withdrawals and distributions	$ ( )
Ending capital account	$ 190,560

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

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

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

1	Ordinary business income (loss)	(100,560)
2	Net rental real estate income (loss)	
3	Other net rental income (loss)	
4a	Guaranteed payments for services	108,000
4b	Guaranteed payments for capital	
4c	Total guaranteed payments	108,000
5	Interest income	
6a	Ordinary dividends	
6b	Qualified dividends	
6c	Dividend equivalents	
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)	
11	Other income (loss)	
12	Section 179 deduction	7,440
13	Other deductions	
14	Self-employment earnings (loss)	A 7,440
15	Credits	J 1,440
16	Schedule K-3 is attached if checked . . . . ► ☐	
17	Alternative minimum tax (AMT) items	
18	Tax-exempt income and nondeductible expenses	C 1,440
19	Distributions	
20	Other information	N 6,000
21	Foreign taxes paid or accrued	

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

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For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

Code M: Credit for Increasing Research Activities. The credit for increasing research activities (commonly termed the R&D credit) is associated with increasing R&D expenditures a business undertakes over a base amount. New IRS guidance became effective in January 2022 for claiming this credit, particularly on amended returns.[108]

> **Note.** For more information on this credit, see the 2021 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Small Business Issues and the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

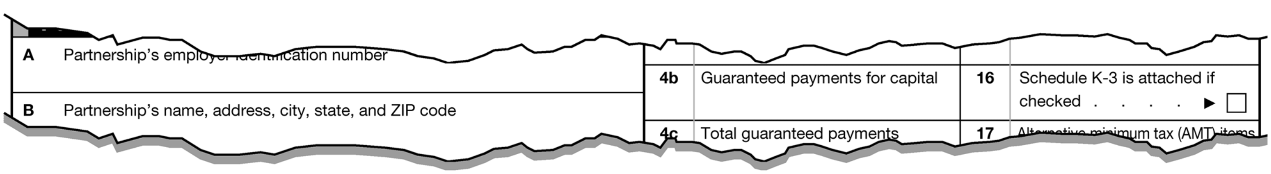
Code N: Credit for Employer Social Security and Medicare Taxes. Better known as the FICA tip tax credit, this credit is most commonly used by restaurants because their employees receive tips frequently. To encourage employers to report tip income and the associated payroll tax, restaurant owners have the incentive to report these items. If the restaurant is taxed as a partnership or an S corporation, this information is provided on Schedule K-1 (Form 1065) using code N in box 15 or Schedule K-1 (Form 1120-S) using code N in box 13.

> **Note.** For a discussion of the credit for employer social security and Medicare taxes, see the 2021 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 6: Small Business Issues.

International Attachment

Schedule K-1 for...	Uses Box...
Form 1065	16
Form 1120-S	14
Form 1041	Not applicable

In 2021, a simple checkbox replaced a larger box on Schedule K-1 to indicate an international attachment. Although the checkbox by itself is simple, if marked, it denotes a Schedule K-3 is attached for the recipient.



The new Schedule K-3 provides information to the K-1 recipient, such as the country or U.S. possession in which a transaction occurred.

Consequently, when a taxpayer receives a Schedule K-1 with this box marked, they are expected to account for the information provided in Schedule K-3, as well.

> **Note.** For more information about Schedule K-3, see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

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108. *Research Credit Claims (Section 41) on Amended Returns: Frequently Asked Questions*. Feb. 9, 2022. IRS. [www.irs.gov/businesses/corporations/research-credit-claims-section-41-on-amended-returns-frequently-asked-questions] Accessed on Jul. 21, 2022.

Alternative Minimum Tax (AMT) Items

Schedule K-1 for...	Uses Box...
Form 1065	17
Form 1120-S	15
Form 1041	12

Because PTEs necessarily pass their items of income and deduction to their owners, items affecting AMT also find their way onto the Schedule K-1 recipients' Forms 6251, *Alternative Minimum Tax — Individuals*. The following discussion assumes that these entity owners are individuals.

Items reported in this box may increase the AMT to which an individual is subject. Some examples of how AMT items affect an individual's Form 6251 follow.

Code A: Post-1986 Depreciation Adjustment.[109] Amounts listed with code A are **preference items** that may increase a taxpayer's alternative minimum taxable income (AMTI) in part I of Form 6251, line 4. The amounts stem from differences in depreciation that is allocable to inventory costs. AMT preference items are applied to the following.

- Items placed in service starting in 1987 for items depreciated using the 200% declining balance method
- §1250 property not depreciated using the straight-line method for regular income tax
- Items placed in service after enactment but before 1999

Code B: Adjusted Gain or Loss. Amounts listed with code B in this box represent the difference in basis between the regular tax basis and the AMT tax basis. Because the difference in these amounts arises from the slower rate at which certain property is depreciated, a preference item may be reported.

109. IRC §57(a)6); Instructions for Form 6251.

Example 6. Use the same facts as **Example 3,** except that on December 31, 2021, Metal Benders, LLC sold a drill press for $6,000. The drill press was placed in service on January 1, 2019, and its unadjusted basis was $10,000. Using the half-year convention, 200% declining balance depreciation, and a 7-year recovery period, Metal Benders has 2021 regular depreciation on this machinery of $875 and AMT depreciation of $752. Joe receives a 2021 Schedule K-1 (Form 1065) showing a post-1986 depreciation adjustment of $74 (($875 regular depreciation – $752 AMT depreciation) × 60%).

Joe's Schedule K-1 (Form 1065) also shows an adjusted loss with code B in box 17 of $686. This amount arises from the difference between the AMT basis at disposition and the regular tax basis at disposition, shown as follows.

Unadjusted basis	$10,000	
Less: accumulated regular depreciation at disposition	(4,753)	
Adjusted basis (regular tax)	$ 5,247	$5,247
Unadjusted basis	$10,000	
Less: accumulated AMT depreciation at disposition	(3,609)	
Adjusted basis (AMT)	$ 6,391	(6,391)
AMT-adjusted gain/(loss)		($1,144)
		× 60%
Joe's share of AMT-adjusted gain/(loss)		($ 686)

The disposition of this property not only creates the two AMT items, but it also affects the §179 expense deduction and SE earnings. Using the half-year convention, $875 of depreciation expense is associated with the lathe, increasing the ordinary business loss in box 1 and decreasing the §179 deduction amount. When Metal Benders sells the lathe at the end of the year, §1231 gain of $753 is created. The ordinary business loss has a net increase of $122 ($875 depreciation expense – $753 §1231 gain). Joe's portion of the net change is $73 ($122 net increase in ordinary business loss × 60% Joe's share). His SE earnings are reduced to $5,475 by his share of the IRC §1245 gain on the sale of the lathe ($108,000 guaranteed payment – $102,073 ordinary business loss – ($753 §1245 loss × 60%)).

A copy of Joe's Schedule K-1 (Form 1065) is shown on the following page.

For Example 6

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

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
99-8888888

B Partnership's name, address, city, state, and ZIP code
Metal Benders, LLC
1200 West Bartlett Rd
Elgin, IL 60120

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 SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
444-55-6666

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Joe Blacksmith
456 Anvil Dr
Elgin, IL 60120

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

H1 ☒ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner?

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ▶ ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	60 %	60 %
Loss	60 %	60 %
Capital	60 %	60 %

Check if decrease is due to sale or exchange of partnership interest . ▶ ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$
Recourse	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 300,000
Capital contributed during the year	$
Current year net income (loss)	$
Other increase (decrease) (attach explanation)	$ (108,000)
Withdrawals and distributions	$ ( )
Ending capital account	$ 192,000

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

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning $
Ending $

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

1	Ordinary business income (loss) **(102,073)**	14	Self-employment earnings (loss) **A** **5,475**
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services **108,000**		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . ▶ ☐
4c	Total guaranteed payments **108,000**	17	Alternative minimum tax (AMT) items **A** **74**
5	Interest income		**B** **(686)**
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		**C**
7	Royalties		
8	Net short-term capital gain (loss)		
		19	Distributions
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)		
		20	Other information
9c	Unrecaptured section 1250 gain		**N*** **STMT**
10	Net section 1231 gain (loss)		**Z*** **STMT**
11	Other income (loss)		
12	Section 179 deduction **5,927**	21	Foreign taxes paid or accrued
13	Other deductions		

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

Fiduciaries filing returns for estates or trusts must also report AMT items to beneficiaries using box 12 of Schedule K-1 (Form 1041). Beneficiaries of estates and trusts report any amount labeled with code A on Form 6251, line 2j. Codes B through F are used as AMT adjustments for items appearing on Schedule D, such as qualified dividends, capital gain, unrecaptured §1250 gain, or 28% collectibles gain. Codes D through I relate to noncash expenses, such as accelerated depreciation, depletion, or amortization.

Tax-Exempt Income and Nondeductible Expenses

Schedule K-1 for...	Uses Box...
Form 1065	18
Form 1120-S	16
Form 1041	Not applicable

Tax-exempt income is reported using code A. **Other income** may be tax-exempt, such as the proceeds of life insurance[110] or income associated with foreign governments or certain international organizations.[111] An explanatory statement must accompany the Schedule K-1 in this event. Code B identifies this income on the Schedule K-1 for both partnerships and S corporations. A similar code does not exist for Schedule K-1 (Form 1041).

Nondeductible expenses are reported with code C, as they reduce a partner's or member's basis. This is often seen with the nondeductible portion of meals and entertainment. This code is used on Schedules K-1 for both partnerships and S corporations. The Schedules K-1 generated by trusts and estates have no code for this purpose.

Distributions

Schedule K-1 for...	Uses Box...
Form 1065	19
Form 1120-S	16
Form 1041	Not applicable

Generally, S corporations report distributions in box 16 of Schedule K-1 (Form 1120-S) using code D. Distributions affect a shareholder's basis but usually are not taxed if the shareholder has a positive basis. This code is used regardless of whether cash or property was distributed.

However, the general rule does not apply if the S corporation distributes an amount exceeding its accumulated adjustments account (AAA) and has previously taxed earnings and profits. Instead, it issues a Form 1099-DIV, *Dividends and Distributions*, to the shareholders who receive the distribution of earnings and profits.[112]

Entities taxed as partnerships report distributions to investors using box 19. Code A is used for distributions of cash or cash equivalents. Code B identifies distributions subject to the so-called "mixing bowl" rules of IRC §737. These rules affect partners who have contributed property with a built-in gain and receive a distribution of other property within seven years.

110. IRC §72(b)(1).

111. IRC §892(b).

112. *Taking the "Sting" Out of S Corporations' Earnings and Profits*. Traum, Sydney S. Dec. 31, 2010. Journal of Accountancy. [www.journalofaccountancy.com/issues/2011/jan/20103334.html] Accessed on Jul. 21, 2022.

Example 7. Aaron, Bonnie, and Clyde formed the ABC Partnership on January 3, 2019.[113] Aaron contributes two pieces of land worth $25,000 each, one in Alabama and one in Arkansas; both were purchased two years earlier for $15,000. Bonnie contributed a piece of land in Wisconsin she purchased in December 2018 for $50,000, which was still its value when she contributed it to the partnership on January 3, 2019. Clyde contributes $50,000 cash. Thus, the three partners have each contributed $50,000 of capital to the ABC Partnership.

In February 2022, after three years in the partnership, Aaron decides he wants to exit. He receives the Wisconsin land from the ABC Partnership as a liquidating distribution. On the same day, the Alabama property is distributed to Bonnie.

Aaron's **net** precontribution gain on the two properties he contributed is $20,000 (($25,000 FMV × 2) – ($15,000 basis × 2). From the distribution to Bonnie, he recognizes $10,000 gain, based on IRC §704(c)(1)(B) and Treas. Reg. §1.704-4 ($25,000 FMV of the Alabama property – $15,000 basis for the Alabama property.) Aaron's net precontribution gain is reduced from $20,000 to $10,000, increasing his adjusted basis in the partnership by $10,000 to $40,000. His receipt of the Wisconsin property as a liquidating distribution results in recognition of a $10,000 gain ($50,000 basis of Wisconsin property – $40,000 adjusted basis in partnership). Aaron receives a final Schedule K-1 (Form 1065) from the partnership with code B followed by an asterisk and "STMT" in the entry space where amounts normally appear. This alerts him to the attached statement that lists the basis of the Wisconsin property distributed to him, as well as the precontribution gain he recognized.[114]

Code C is used to account for property other than cash or §737 property. The amount provided on Schedule K-1 is the entity's adjusted basis in the property. If the property distributed is a part of a liquidating distribution, some of the distribution may represent ordinary income because it is attributable to the individual's share of the business's hot assets, such as accounts receivable or inventory, that normally produce ordinary income when realized as income.[115]

Distributions are discussed in greater detail later.

Other Information

Schedule K-1 for...	Uses Box...
Form 1065	20
Form 1120-S	17
Form 1041	14

Other information that does not fit in any other category on Schedule K-1 is reported in this box. In 2021, partnerships offered 33 options for reporting additional items to its recipients and S corporations offered 24 options. The following are some of the noteworthy codes **partnerships** use in this box. Beneficiaries receiving Schedules K-1 (Form 1041) may see any of 10 codes.

113. Example adapted from Treas. Reg. §1.737-1.

114. Instructions for Form 1065.

115. Treas. Reg. §1.751-1(a).

Code U: §743(b) Basis Adjustment. This adjustment to a partner's basis arises from the difference between their outside basis and the inside basis of the partner's share of assets owned by the partnership. The adjustment is only possible if the partnership has made an election under §754 to adjust the basis of a partnership interest transferred to another individual. The transfer may be the result of a partner's death or simply the disposition of their interest in the partnership. The basis adjustment may be further categorized along the following lines.

- Buildings and other depreciable assets
- Depletable assets
- Intangible assets
- Other assets

Code W: Precontribution Gain. This code is used when one partner receives property that another partner has contributed within the past seven years and that property has a gain at the time of its contribution. If the partnership distributed any property with precontribution gain or loss to any partner other than the contributing partner and the date of the distribution was within seven years of the date the property was contributed to the partnership, the contributing partner must recognize a gain or loss under §704(c)(1)(B). If the partnership made such a distribution during its tax year, in addition to indicating the distribution in box 20 with code W, it must attach a statement providing the amount of the partner's precontribution gain or loss and identifying the character of the gain or loss (for example, capital gain or loss, or §1231 gain or loss). The precontribution gain or loss is reported on Form 8949, *Sales and Other Dispositions of Capital Assets,* and Schedule D or Form 4797 in accordance with the information provided by the partnership.

Foreign Taxes Paid or Accrued

Schedule K-1 for...	Uses Box...
Form 1065	21
Form 1120-S	16
Form 1041	14

A new box appeared on the Schedule K-1 for partnerships in 2021, and it concerns foreign taxes paid or accrued. This information previously was reported in box 16 with code P if the taxes were paid and code Q if they were accrued. The amount of foreign tax reported in this box is intended for the calculation of basis, rather than the calculation of foreign tax that may be either creditable or deductible. Schedule K-1 (Form 1065) provides the amount with no code associated with it.

When an S corporation reports foreign tax to its shareholders, it uses box 16 with code F because it affects the shareholder's basis.[116] Beneficiaries may receive a Schedule K-1 (Form 1041) with an amount in box 14 with code B, which designates foreign tax payment or accrual.[117]

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116. Instructions for Schedule K-1 (Form 1120-S).

117. Instructions for Schedule K-1 (Form 1041).

BASIS LIMITATIONS

Even when a Schedule K-1 recipient 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.[118]

Basis Limitation

To be deductible, a loss must not exceed the individual's basis in their stock, plus certain debt basis.[119] A loss that is deductible reduces the individual's basis at the close of that year. Basis cannot be reduced below zero.

> **Note.** For more information on basis limitations, see the 2022 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

At-Risk Rules

When a Schedule K-1 reports an ordinary loss, 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:

- The **amount of money contributed** and the adjusted basis of other property contributed to the entity by the taxpayer, plus
- **Amounts borrowed** related to the activity for which the individual has personal liability.[120]

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.

Passive Loss Rules[121]

The passive loss rules substantially limit the benefits of an inactive investor. **The passive loss rules apply to all rental activities and any other activity that does not involve material participation by the taxpayer.[122]**

The Schedule K-1 recipient treats nonseparately stated income as active income if they **materially participate** in the activity. If they did **not** materially participate, their nonseparately stated income is considered passive.[123]

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 there is income from a passive activity or the activity is disposed of in a taxable transaction.[124]

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 MAGI is between $100,000 and $150,000.

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118. IRC §465.
119. IRC §1366(d)(1).
120. IRC §465(b)(1).
121. IRC §469.
122. IRC §469(h)(1).
123. Instructions for Schedule K-1 (Form 1120-S).
124. IRC §469(b).

Form 8582 shows the limitation of the loss and suspends the loss for future years.[125] By law, **limited partners** cannot materially participate in the partnership and maintain their limited liability.[126] Therefore, they are considered passive investors.

Example 8. 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 Schedule K-1 (Form 1065), in part III, box 1. Mark is at-risk for the loss because his at-risk basis of $5,000 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 at risk for only $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 reports a cumulative passive loss of $5,000, while Form 6198 shows a deductible loss **for at-risk purposes only** of $3,000.

Passive Loss Rules Exceptions.[127] 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 Schedule K-1 to indicate the taxpayer is a real estate professional. If the taxpayer meets the criteria for a 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.

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 Schedule 1 (Form 1040), line 5 ▶			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 1120-S), box 17, code AD; and Schedule K-1 (Form 1041), box 14, code F. See instructions . .	42			
43	**Reconciliation for real estate professionals.** If you were a real estate professional (see instructions), enter the net income or (loss) you reported anywhere on Form 1040, Form 1040-SR, or Form 1040-NR from all rental real estate activities in which you materially participated under the passive activity loss rules	43			

Schedule E (Form 1040) 2021

To be a real estate professional, an individual must perform **more** than:[128]

- Half 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.[129]

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125. Instructions for Form 8582.
126. IRC §469(h)(2).
127. IRC §469(c)(7).
128. IRC §469(c)(7)(B).
129. IRC §469(c)(7)(C).

Passive Activity Credits.[130] Passive activity credits are allowed even when a loss on the Schedule K-1 is not allowed due to passive limitations. For example, the **low-income housing credit** is often associated with a passive activity. 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 AMT issues.

Example 9. 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 D, 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 10. Use the same facts as **Example 9,** except Brenda's box 2 of Schedule K-1 reports a $28,000 rental real estate loss, and box 15 (code D) 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.

CASH AND PROPERTY DISTRIBUTIONS

Taking distributions from an entity without incurring income tax is an attraction of PTEs. Tax-free distributions from partnerships or S corporations are a possibility, but significant complications may accompany them. Trusts and estates may make distributions to beneficiaries; however, these distributions are not reported on Schedule K-1 (Form 1041), and accordingly are not covered in this material.

Cash Distributions

Distributions from Partnerships. IRC §731(a) provides that distributions of money to partners (including liability relief) are tax-free to the extent of the partner's outside basis in the partnership. For this purpose, the FMV of marketable securities distributed to the partner may be treated as money.[131] The partner's basis is reduced to the extent of money distributed. Distributions of money in excess of basis are treated as gain from a constructive sale of the partnership interest. This results in short- or long-term capital gain except to the extent such distributions are governed by IRC §§736, 737, and 751.[132] If both money and property are distributed, the partner's basis is always reduced first to the extent of money distributed.[133] No loss can be recognized with respect to current (as opposed to liquidating) distributions.[134] The partnership recognizes neither gain nor loss on a distribution.[135]

> **Note.** Although money distributions in excess of a partner's basis are treated as the sale or exchange of a capital asset,[136] the look-through rule for capital gain rates (i.e., the gain must be allocated to the selling partner's proportionate interest in any partnership collectibles and unrecaptured §1250 gain, with the residual balance treated as long-term capital gain) does not apply to the "redemption" of the partnership interest.[137] Although the term redemption is not specifically used under §736 to describe the liquidation of a partner's interest, the substance of those transactions should be treated as redemption for this purpose.
>
> For more information on redemptions, see the 2017 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 5: Partnership Issues. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

130. IRC §469(d)(2).
131. IRC §731(c). Certain exceptions are provided for securities distributed to the contributing partner and for investment partnerships.
132. IRC §731(d).
133. IRC §732(a)(2).
134. Ibid.
135. IRC §731(b).
136. IRC §731(a).
137. Treas. Reg. §§1.1(h)-1(b)(2)(ii) and (b)(3)(ii).

Example 11. Doris has a partnership basis of $20,000, and she receives a cash distribution of $25,000, which is shown on Schedule K-1 in box 19 with code A. She has held the partnership interest longer than one year. The first $20,000 of the distribution is tax-free, and Doris's basis is reduced from $20,000 to $0. The remaining $5,000 of distribution is treated as though Doris received it in exchange for a sale of her partnership interest. This part of the distribution is long-term capital gain.

Distributions from S Corporations.[138] IRC §1368 covers distributions that S corporations make to their shareholders and provides that distributions are not taxed to the extent they do not exceed a taxpayer's adjusted basis in the stock. Distributions in excess of a shareholder's stock basis are treated in the same manner as gains from the sale of the stock. The major problem for these shareholders is to determine how much basis is available at the time of the distribution. Form 7203, *S Corporation Shareholder Stock and Debt Basis Limitations*, was introduced for 2021 tax returns to provide some consistency with this task.[139]

> **Note**. For more information on Form 7203, see the 2022 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 1: New Developments.

A shareholder increases their basis for income from the S corporation and decreases their basis for losses and distributions. If basis (last year's ending basis plus this year's income) exceeds the current year's losses, the distributions are tax-free to the shareholder. When the losses exceed the sources of basis, ordering rules become important.

Basis Adjustments for Income and Losses. Shareholders must adjust their stock basis annually for the allocable portion of S corporation income and losses. When there is more than one shareholder during the tax year, the corporation must allocate each item of income or loss on a per-day, per-share basis. However, all basis adjustments are deemed to occur at the end of each tax year. If a shareholder disposes of their entire ownership during a year, the basis is adjusted on the final day that the person owned the stock.

Interaction Between Basis Adjustments and Distributions. When there is enough basis to absorb both losses and distributions for the year, the shareholder claims both as a reduction of basis. The losses may be subject to other limitations, such as at-risk and passive activity loss limits; however, the distributions are tax-free.

Practitioner Planning Tip

If a client receives a Schedule K-1 (Form 1120-S), it is critical for the practitioner to obtain the basis worksheet from the practitioner who prepared the S corporation tax return. The beginning basis from the worksheet is necessary to complete Form 7203.

138. IRC §1368.

139. Instructions for Form 7203.

Property Distributions

Distributions from Partnerships. IRC §732(a) provides that the basis of property other than money distributed as part of a current distribution is its adjusted basis to the partnership immediately prior to the distribution. However, this basis may not exceed the distributee-partner's basis in the partnership immediately prior to the distribution and after the reduction for any money distributed.

If the distributee-partner's basis in the partnership is less than the bases in properties distributed (after reduction for money distributed), the partner's basis is first allocated among unrealized receivables and inventory. Any remaining basis is allocated among other distributed properties in proportion to the partnership's bases in the properties. The partner is then left with a zero basis in the partnership.

The point of the property distribution rules is to defer the taxation of any gain or loss on the distributed property until the distributee-partner disposes of it.[140] This is in contrast to property distributions from corporations, which are generally treated as being fully taxable to both the corporation and the distributee-shareholder.[141]

Example 12. Scott receives a current distribution from a partnership at a time when his basis in the partnership is $10,000. The distribution consists of $7,000 of cash and §1231 property (property used in a trade or business and held for more than one year) with an adjusted basis of $5,000 and an FMV of $9,000. Scott recognizes no gain because the $7,000 cash received does not exceed his $10,000 basis in the partnership. Scott's partnership basis is reduced from $10,000 to $3,000. His remaining $3,000 partnership basis is substituted as his basis in the §1231 property.

If Scott sells the property for its $9,000 FMV, he recognizes $6,000 of gain. This is because Scott originally received a distribution with a total value of $16,000 when he had only $10,000 of basis, but he was not taxed at that time for the distribution in excess of his basis.

Example 13. Renee has a partnership basis of $15,000. She receives a distribution consisting of $5,000 of cash, inventory with an adjusted basis of $6,000, and two pieces of real property. Property A has a partnership basis of $6,000, and Property B has a partnership basis of $2,000. Renee's basis in the partnership is first reduced from $15,000 to $10,000 by the cash distribution. Her remaining $10,000 basis is first allocated to the inventory, giving it a full carryover basis of $6,000. Her remaining $4,000 of basis is allocated between the two pieces of real property in proportion to their bases in the hands of the partnership prior to the distribution. Thus, Property A receives a basis of $3,000 ($4,000 remaining basis × ($6,000 Property A basis ÷ $8,000 total partnership basis for Properties A and B)). Property B receives a basis of $1,000 ($4,000 remaining basis × ($2,000 Property B basis ÷ $8,000 total partnership basis for Properties A and B)).

If the distributed property is subject to a liability that is assumed by the distributee-partner, the partner's basis in the partnership is:

- Increased by the liabilities assumed in connection with the distribution,[142]
- Decreased by the partner's resulting reduction in partnership liabilities,[143] and
- Decreased by the basis of the distributed property.[144]

140. IRC §732(a)(1).
141. IRC §311.
142. IRC §752.
143. Ibid.
144. IRC §733(2).

Example 14. Ryan has a partnership basis of $3,000. He receives a current distribution of property with an FMV of $12,000. The property has an adjusted basis to the partnership of $5,000 and is subject to a liability of $10,000. At the time of distribution, $6,000 of the liability was included in Ryan's basis. He receives a carryover basis of $5,000 in the distributed property and has a $2,000 basis remaining in the partnership ($3,000 initial basis + $10,000 of liabilities assumed – $6,000 decrease in partnership liabilities – $5,000 basis in distributed property). Ryan's remaining $2,000 basis in the partnership interest is because his outside partnership basis cannot be allocated to the distributed property in excess of the partnership's adjusted basis in the property.

Distributions from S Corporations. The S corporation must recognize gain on the distribution of **appreciated** property but may not recognize losses on distributions of depreciated property.[145] The shareholder takes a basis in the property equal to its FMV.[146]

Compliance

Schedule K-1 reports distributions to the owner of the PTE. If the distributions exceed the owner's interest in the PTE, the cash or property distributed in excess of the basis is generally treated as the sale of a capital asset on the owner's return.

However, a distribution may result in an **ordinary** gain in some circumstances, particularly when the PTE is a partnership. Cash or property distributed may be attributable to a partner's share of the following.[147]

- Unrealized receivables
- Inventory items

The portion of the distribution attributable to these items is considered ordinary income. Although the instructions for Schedule K-1 (Form 1065) include instructions for identifying such a distribution, they refer to the possibility. Without being provided more direction, a partner could reasonably report them on line 8z (other income) of Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*. There is no equivalent for S corporation shareholders.

Partnership Compliance Issues. Code C in **box 19** of Schedule K-1 (Form 1065) reports the partnership's adjusted basis of property other than money distributed from the partnership to the partner. If more than one property is distributed, the partnership must report the adjusted basis and FMV of each. The determination of the property's basis depends on whether it is **a liquidating or nonliquidating** distribution.

Payments made to a retiring partner under §736(a) or the successor to or estate of a deceased partner will be taxed as **ordinary income**. If payments are based on a share of partnership profit, the partnership will issue a Schedule K-1 reflecting the partner's distributive share of partnership items. If the payments are treated as guaranteed payments, the Schedule K-1 should reflect that. In either case, a retiring partner is subject to SE tax if the partner was a general partner, regardless of the fact that the partner is retired.[148] It is possible to structure retirement payments to a retired partner under IRC §1402(a)(10) in such a manner that they will not be subject to SE tax. However, any such plan must comply strictly with the regulations and may not suit the needs of the partnership or retiring partner.[149]

If deferred §736(a) payments are being made to a deceased partner's successor, a Schedule K-1 must also be issued showing the payments as either a distributive share of partnership income or a guaranteed payment. Amounts should not be entered on box 14 of the Schedule K-1 for net earnings or an SE loss (code A) for any partner that is an estate, trust, corporation, exempt organization, or IRA. If an individual successor in interest to a deceased partner has not been admitted as a substitute partner, there should also be no entry on line 14 because that individual is not a partner[150] and therefore has no SE income under §1402(a) as a partner in the partnership.

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145. IRC §311(b).
146. IRC §§301(b) and 1371(a).
147. IRC §751(a); Treas. Reg. §1.751-1(a).
148. Treas. Reg. §1.1402(a)-2.
149. Treas. Reg. §1.1402(a)-17.
150. IRC §761(b).

S Corporation Compliance Issues. S corporation distributions of any kind are reported in **box 16** of Schedule K-1 (Form 1120-S). The shareholder is responsible for determining stock and debt basis and using Form 7203 to report any basis changes due to distributions.

> **Note.** For more information on Form 7203, see the 2022 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: New Developments.

Difficulties may arise if shareholders do not receive distributions in proportion to their ownership of S corporation stock. Governing corporate documents, as well as state laws, are generally determinative of whether outstanding corporate stock provides equal distribution and liquidation rights to all shareholders. Circumstances involving actual, constructive, or deemed distributions that differ among shareholders in timing or amounts may be construed as creating a prohibited second class of stock.[151] The shareholder's respective ownership should be reflected in proportionate distributions. However, the Tax Court has held that an unequal distribution alone does not result in a second class of stock if the outstanding shares are actually entitled to equal distributions.[152]

SE IMPLICATIONS

IRC §1402(a) includes the distributive share of a **partner's** income in their net earnings from SE activities. This section of the Code does not mention S corporations or trusts. Because S corporation shareholders are by definition employees,[153] SE income from the S corporation is not an option for them, and they have a responsibility to comply with reasonable compensation requirements as employees.[154] For these reasons, only partnerships are discussed in this section.

Reporting Gross Income[155]

A general partner is subject to SE tax on profits passed through from the partnership and on guaranteed payments received from the partnership. Box 14 shows the **unadjusted** amount of net income subject to SE tax and other amounts that a taxpayer needs if they choose to use the farm or nonfarm optional methods to calculate their SE tax.

- **Code A** reports the partner's portion of net earnings subject to SE tax plus the guaranteed payments received by the partner. The partner should adjust this amount by any separately stated items from the Schedule K-1 that affect their net taxable earnings subject to SE tax. Only the portion of the separately stated item claimed on the individual partner's return should be included in the adjustment.
- **Code B** reports the partner's portion of gross farming and fishing income from activities subject to SE tax and may allow the taxpayer to qualify as a farmer for estimated tax purposes. Individual partners need this amount to calculate net earnings from SE activities under the farm-optional method in section B, part II of Schedule SE.
- **Code C** reports the partner's portion of gross nonfarm income from activities subject to SE tax. Individual partners need this amount to calculate net earnings from SE activities under the nonfarm optional method in section B, part II of Schedule SE.

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151. Treas. Reg. §1.1361-1(l)(2)(i).

152. *Linda K. Minton v. Comm'r*, 562 F.3d 730 (5th Cir. 2009), *aff'g* TC Memo 2007-32 (Dec. 26, 2007); *Craig P. and Cricket U. Mowry v. Comm'r*, TC Memo 2018-105 (Jul. 5, 2018).

153. IRC §3121(d)(1); Treas. Reg. §31.3121(d)-1(b).

154. IRC §1366(e).

155. Instructions for Form 1065.

Note. The amounts reported under codes B and C are **not** included on the individual's tax return but are necessary to determine if a taxpayer qualifies for the optional methods. The amounts may also be useful in determining if a taxpayer meets certain gross income tests for Code provisions applicable only to taxpayers who qualify as farmers. For example, farmers qualify for special provisions regarding payment of estimated income taxes.

The optional methods of calculating SE earnings may be used by taxpayers who want credit towards their social security coverage even though they have a loss or a small amount of SE income. A worker can use the optional method if their net income from nonfarm SE activities is less than $6,367 for 2021 and also less than 72.189% of their gross nonfarm income. In addition, they must have net SE earnings of at least $400 in two of the last three years.[156]

The farm optional method may be used if either gross income from farm SE activities is $8,820 or less, or net farm profits is less than $6,367.[157] Additional requirements for the nonfarm optional method can be found in the instructions for Schedule SE.

Incorporating §179 Expense Deduction[158]

A taxpayer's net earnings from SE activities provided in box 14 of Schedule K-1 (Form 1065) with code A should be adjusted for separately stated items. This adjustment should include any amount associated with the §179 expense deduction that a Schedule K-1 recipient can take. The following example illustrates how §179 expense can be used to reduce a Schedule K-1 recipient's SE earnings.

Example 15. Ethan is a 25% partner in TFM, LLC, which is his only source of income in 2021. Ethan received the Schedule K-1 (Form 1065) shown on the following page from the LLC for 2021. Although the business incurred an ordinary loss of $15,000 for the year, it paid Ethan $44,000 in guaranteed payments for his services and passed through a §179 expense deduction of $8,000 as his 25% share.

For §179 purposes, Ethan's business income was $29,000 ($44,000 guaranteed payments – $15,000 loss) (shown in box 14, code A). Ethan deducted the full §179 deduction of $8,000 passed through to him from the LLC. His net SE earnings were $21,000 ($29,000 business income - $8,000 §179 deduction).

Note. Guaranteed payments, like wages, are not added back to net income or considered separately as QBI even though, in all likelihood, the guaranteed payments are subject to SE tax.

156. *If You Are Self-Employed*. 2022. SSA. [www.ssa.gov/pubs/EN-05-10022.pdf] Accessed on Jul. 21, 2022.

157. Ibid.

158. Rev. Rul. 65-272, 1965-2 CB 217.

For Example 15

651121

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**
Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year beginning / / 2021 ending / /

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
44-3456789

B Partnership's name, address, city, state, and ZIP code
TFM LLC
45 Callow Ln
Allentown, PA 18104

C IRS center where partnership filed return ▶ Ogden

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

Part II Information About the Partner

E Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)
333-44-5678

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.
Ethan Lonesome
13 S 5th Ave
Allentown, PA 18104

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

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:
TIN ______ Name ______

I1 What type of entity is this partner? Individual

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ▶ ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	25 %	25 %
Loss	25 %	25 %
Capital	25 %	25 %

Check if decrease is due to sale or exchange of partnership interest . ▶ ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse	$	$
Qualified nonrecourse financing	$	$
Recourse	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L **Partner's Capital Account Analysis**

Beginning capital account	$ 50,000
Capital contributed during the year	$
Current year net income (loss)	$ (23,000)
Other increase (decrease) (attach explanation)	$
Withdrawals and distributions	$ ( )
Ending capital account	$ 27,000

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

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**
Beginning . . . . $
Ending . . . . $

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

1	Ordinary business income (loss)	(15,000)	14	Self-employment earnings (loss)	
				A	29,000
2	Net rental real estate income (loss)			C	100,000
3	Other net rental income (loss)		15	Credits	
4a	Guaranteed payments for services	44,000			
4b	Guaranteed payments for capital		16	Schedule K-3 is attached if checked . . . . ▶ ☐	
4c	Total guaranteed payments		17	Alternative minimum tax (AMT) items	
5	Interest income				
6a	Ordinary dividends				
6b	Qualified dividends		18	Tax-exempt income and nondeductible expenses	
6c	Dividend equivalents				
7	Royalties				
8	Net short-term capital gain (loss)		19	Distributions	
9a	Net long-term capital gain (loss)				
9b	Collectibles (28%) gain (loss)		20	Other information	
9c	Unrecaptured section 1250 gain			Z	(15,000)
10	Net section 1231 gain (loss)			AA	0
11	Other income (loss)			AB	200,000
				AC	0
12	Section 179 deduction	8,000	21	Foreign taxes paid or accrued	
13	Other deductions				

22 ☐ More than one activity for at-risk purposes*
23 ☐ More than one activity for passive activity purposes*
*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R Schedule K-1 (Form 1065) 2021

Contrasting General and Limited Partners[159]

General partners have unlimited liability for the liabilities of the partnership, and therefore include the box 1 ordinary income in their SE earnings. In this sense, they are analogous to sole proprietors, except that the entity for which they work has additional equity owners. General partners have the obligation to satisfy obligations of the partnership, especially recourse liabilities.

Limited partners have the following characteristics.[160]

- No personal liability for the debts or obligations of the partnership, even in the partnership's recourse liabilities
- No authority to bind the partnership under contract
- Do not work in the partnership's business for more than 500 hours during the tax year

Limited partners generally do not include their share of the partnership's ordinary business income or loss in their SE earnings.[161] However, in determining whether a partner is a limited partner, courts look beyond simple labels attached to their interests to see if any of the previously listed characteristics points to general liability. In an important case involving the partners of a law firm specializing in tax law, the Tax Court decided that even if a partner officially has a "limited partnership interest," their activities in providing legal services meant that they were general partners and that the ordinary business income of the partnership made them liable for SE tax.[162]

Practitioner Planning Tip

Tax practitioners who work with partnerships may find the off-season the best time to collect partnership agreements from the partnerships with which they work if they do not already have them. Being familiar with the state statutes governing partnerships and LLCs may also prove useful when later preparing partnership returns.

QBID

A PTE must determine and separately report the following items for **each** of the relevant pass-through entity's (RPE) trades or businesses.[163]

- QBI
- Form W-2 wages
- Unadjusted basis immediately after acquisition (UBIA) of qualified property
- Whether the trade or business is a specified service trade or business (SSTB)

The RPE must also report each owner's allocated share of any qualified REIT dividends received by the RPE (including through another RPE) as well as any qualified PTP income or loss received by the RPE for each PTP in which the RPE holds an interest (including through another RPE).

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159. IRC §1402(a); Treas. Reg. §1.1402(a)-2(d).
160. Prop. Treas Reg. §1.1402(a)-2(h).
161. IRC §1402(a)(13); Treas. Reg. §1.1402(a)-2(d).
162. *Renkemeyer, Campbell & Weaver, LLP v Comm'r*, 136 TC 137 (2011).
163. Treas. Reg. §1.199A-6(b)(3)(i).

An RPE may aggregate its trades or businesses provided it meets the rules of Treas. Reg. §1.199A-4. An RPE that chooses to aggregate must compute and report the QBI, Form W-2 wages, and UBIA of the aggregation under the rules described in Treas. Reg. §1.199A-6(b).[164] Under these rules, the RPE may determine and report required QBI items for the aggregated trade or business.[165]

If an RPE fails to separately identify or report an item of QBI, Form W-2 wages, or UBIA of qualified property, then **only** the owner's share of each unreported item is presumed to be zero.[166] The applicable information should be reported on the Schedule K-1 or on an attachment to the Schedule K-1 that is issued to an owner. In addition, the RPE can report the relevant information on an amended or late-filed return if the statute of limitations remains open.[167]

Practitioner Planning Tip

If the RPE does not report applicable items, the amount of QBI available to the Schedule K-1 recipients is zero. If a practitioner believes this to be in error, the issuer of the Schedule K-1 should be contacted to determine why IRC §199A information was omitted.

Effect of RPE §179 Election on QBI. When an S corporation makes an §179 expensing election, the shareholder's portion of the §179 expense must be stated separately from ordinary income reported on Schedule K-1, line 1.[168] Similarly, a partner's share of a partnership's §179 expense must be separately stated.[169]

A partner or S corporation shareholder can only currently deduct their share of the RPE's §179 deduction to the extent that they have taxable income from the active conduct of a trade or business during the year.[170] Any §179 deduction disallowed under this rule is carried forward indefinitely until there is taxable income from the active conduct of a trade or business against which it can be offset.[171] Therefore, because the RPE does not necessarily have information about whether the partner/shareholder can currently deduct their share of the RPE's §179 expense, the question arises as to whether the RPE should reduce the partner/shareholder's QBI by their respective share of the §179 expense.

Pursuant to Treas. Reg. §1.199A-3(b)(2)(i), the term qualified items of income, gain, deduction, and loss means items of gross income, gain, deduction, and loss to the extent they are included or allowed in determining taxable income for the tax year.

An S corporation reports a shareholder's portion of QBI on Schedule K-1, line 17, with code V, whereas a partnership reports a partner's portion of QBI on Schedule K-1, line 20, with code Z. Instructions for 2021 versions of Forms 1120-S and 1065 contain flowcharts that indicate §179 deductions reduce QBI.[172]

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164. Treas. Reg. §1.199A-4(b)(2)(ii).
165. Treas. Reg. §1.199A-6(b)(2).
166. Treas. Reg. §1.199A-6(b)(3)(iii).
167. Ibid.
168. Treas. Reg. §1.1366-1(a)(2)(vi).
169. Treas. Reg. §1.179-2.
170. Treas. Reg. §1.179-2(c).
171. Treas. Reg. §1.179-3.
172. 2021 Instructions for Form 1120-S; 2021 Instructions for Form 1065.

Practitioner Planning Tip

Earlier versions of the instructions for these forms did not contain these flowcharts, so it is important that the preparer of the RPE's return effectively communicate to the partner or shareholder whether their share of the QBI reported on the Schedule K-1 is reduced by their respective share of the §179 expense. This can be achieved by attaching an appropriate explanatory statement to the Schedule K-1.

Note. For more information on reporting QBID on Schedule K-1, see the 2019 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 1: QBID Update. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

NET INVESTMENT INCOME TAX (NIIT) ISSUES[173]

NIIT is an additional tax levied on certain taxpayer's investment income. The tax is currently imposed at a rate of 3.8% on individuals having MAGI exceeding the following amounts based on filing status.[174] For NIIT purposes, investment income is generally taxable interest, ordinary dividends, annuities, rents from real estate, royalties, and generally passive income from PTEs. It also includes net gain from the sale of property, provided it is not used in a trade or business.[175]

Filing Status	Threshold Amount
Single, HoH	$200,000
MFJ, QW	250,000
MFS	125,000

However, S corporation and partnership income passed through to a taxpayer is subject to NIIT only if they do **not materially** participate in the operations of the company.[176] Schedules K-1 (Form 1120-S) report NIIT in box 17 with code U, while Schedules K-1 (Form 1065) report NIIT in box 20, other information, with code Y.

Income from Schedule K-1 is generally included on line 4a of Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts*. Income from dispositions of property that is reported on a Schedule K-1 is included on line 5a.

Note. If the taxpayer materially participates in the activity of the entity, an adjustment must be made on lines 4b and 5b of Form 8960 to subtract the income not subject to the NIIT.[177]

173. IRC §1411.
174. IRC §1411(b).
175. IRC §1411(c)(1)(A).
176. Treas. Reg. §1.1411-4(b)(3). See example 4.
177. IRC §1411; Instructions for Form 8960.

Example 16. Sapphire owns shares in Newton Publishing, Inc. (Newton), an S corporation. She is single and a passive investor. Sapphire spent no time working for the company during 2021. Her 2021 Schedule K-1 shows ordinary business income of $1 million, a net §1231 gain of $50,000, and a §179 deduction of $10,000. On Form 8960, Sapphire reports $1 million on line 4a. The $50,000 §1231 gain is reported on line 5a. Her Form 8960 is shown on the following page.

Sapphire's $32,300 NIIT is calculated by multiplying the sum of her income from Newton less the $200,000 threshold amount by the 3.8% NIIT tax rate (($1 million ordinary income + $50,000 §1231 net gains – $200,000 threshold amount) × 3.8%). Her NIIT of $32,300 carries through to line 23 (other taxes) of her Form 1040, where it adds the NIIT to her regular income tax.

For Example 16

Form **8960** — Department of the Treasury, Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 — 2021 — Attachment Sequence No. 72

Name(s) shown on your tax return	Your social security number or EIN
Sapphire	111-22-1111

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	1,000,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b			
c	Combine lines 4a and 4b			4c	1,000,000
5a	Net gain or loss from disposition of property (see instructions)	5a	50,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	50,000
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	1,050,000

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	1,050,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	1,050,000		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	850,000		
16	Enter the smaller of line 12 or line 15			16	850,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	32,300
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from line 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2021)

Example 17. Use the same facts as **Example 16,** except that Sapphire works for Newton, receives reasonable compensation of $55,000, and materially participates in the operations of the company.

To show that these items of income were not subject to NIIT, the qualifying excluded amounts were reported on lines 4b and 5b, respectively. The relevant portion of Sapphire's 2021 Form 8960 is shown on the following page.

Because she materially participated in the operations of the company, the $10,000 §179 deduction from her Schedule K-1 is subtracted from the $1 million ordinary business income before being entered on line 4a of Form 8960. In addition, this amount is used to adjust the amount as an entry on line 4b, resulting in no investment income from Newton's ordinary business income.

Similarly, the net §1231 gain is adjusted by $50,000, resulting in Sapphire having no NIIT. Even though Sapphire's MAGI on line 13 as a passive investor increased from $1,050,000 to $1,095,000, her NIIT was reduced to $0 because she materially participated in the operations of the company. The following table shows how Sapphire's being a passive investor or a material participant affects her MAGI.

	Passive Investor	Material Participant
Ordinary gain	$1,000,000	$1,000,000
§1231 gain	50,000	50,000
Salary		55,000
§179 deduction		(10,000)
MAGI	$1,050,000	$1,095,000

2

For Example 17

Form **8960** Department of the Treasury Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.
▶ Go to *www.irs.gov/Form8960* for instructions and the latest information.

OMB No. 1545-2227 | 2021 | Attachment Sequence No. **72**

Name(s) shown on your tax return: **Sapphire** | Your social security number or EIN: **111-22-1111**

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	
2	Ordinary dividends (see instructions)			2	
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	990,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	(990,000)		
c	Combine lines 4a and 4b			4c	
5a	Net gain or loss from disposition of property (see instructions)	5a	50,000		
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b	(50,000)		
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11, from Part I, line 8. Individuals, complete lines 13–17. Estates and trusts, complete lines 18a–21. If zero or less, enter -0-			12	0
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	1,095,000		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	895,000		
16	Enter the smaller of line 12 or line 15			16	
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			17	
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from line 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (0.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2021)

APPENDIX — BLANK FORMS

Form 1065, Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1065) **2021**

Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

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

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 SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

F Name, address, city, state, and ZIP code for partner entered in E. See instructions.

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

H1 ☐ Domestic partner ☐ Foreign partner

H2 ☐ If the partner is a disregarded entity (DE), enter the partner's:

TIN ________ Name ________

I1 What type of entity is this partner? ________

I2 If this partner is a retirement plan (IRA/SEP/Keogh/etc.), check here ▶ ☐

J Partner's share of profit, loss, and capital (see instructions):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%

Check if decrease is due to sale or exchange of partnership interest . ▶ ☐

K Partner's share of liabilities:

	Beginning	Ending
Nonrecourse . . .	$	$
Qualified nonrecourse financing	$	$
Recourse	$	$

Check this box if Item K includes liability amounts from lower tier partnerships ▶ ☐

L **Partner's Capital Account Analysis**

Beginning capital account . . . . $________

Capital contributed during the year . . $________

Current year net income (loss) . . . . $________

Other increase (decrease) (attach explanation) $________

Withdrawals and distributions . . . . $ ( )

Ending capital account . . . . . $________

M Did the partner contribute property with a built-in gain (loss)?

☐ **Yes** ☐ **No** If "Yes," attach statement. See instructions.

N **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**

Beginning . . . . $________

Ending . . . . $________

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

1	Ordinary business income (loss)	14	Self-employment earnings (loss)
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	15	Credits
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . ▶ ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends	18	Tax-exempt income and nondeductible expenses
6c	Dividend equivalents		
7	Royalties		
8	Net short-term capital gain (loss)		
		19	Distributions
9a	Net long-term capital gain (loss)		
9b	Collectibles (28%) gain (loss)		
		20	Other information
9c	Unrecaptured section 1250 gain		
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction	21	Foreign taxes paid or accrued
13	Other deductions		

22 ☐ More than one activity for at-risk purposes*

23 ☐ More than one activity for passive activity purposes*

*See attached statement for additional information.

For IRS Use Only

For Paperwork Reduction Act Notice, see the Instructions for Form 1065. www.irs.gov/Form1065 Cat. No. 11394R **Schedule K-1 (Form 1065) 2021**

Form 1120-S, Schedule K-1, *Shareholder's Share of Income, Deductions, Credit, etc.*

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☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0123

Schedule K-1 (Form 1120-S) **2021**

Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

Shareholder's Share of Income, Deductions, Credits, etc. ▶ **See separate instructions.**

Part I Information About the Corporation

A Corporation's employer identification number

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

C IRS Center where corporation filed return

D Corporation's total number of shares
Beginning of tax year . . . . . ______
End of tax year . . . . ______

Part II Information About the Shareholder

E Shareholder's identifying number

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

G Current year allocation percentage . . . ______ %

H Shareholder's number of shares
Beginning of tax year . . . . . ______
End of tax year . . . . ______

I Loans from shareholder
Beginning of tax year . . . . . $ ______
End of tax year . . . . $ ______

For IRS Use Only

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

1	Ordinary business income (loss)	**13**	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)		
4	Interest income		
5a	Ordinary dividends		
5b	Qualified dividends	**14**	Schedule K-3 is attached if checked . . . . ▶ ☐
6	Royalties	**15**	Alternative minimum tax (AMT) items
7	Net short-term capital gain (loss)		
8a	Net long-term capital gain (loss)		
8b	Collectibles (28%) gain (loss)		
8c	Unrecaptured section 1250 gain		
9	Net section 1231 gain (loss)	**16**	Items affecting shareholder basis
10	Other income (loss)		
		17	Other information
11	Section 179 deduction		
12	Other deductions		

18 ☐ More than one activity for at-risk purposes*
19 ☐ More than one activity for passive activity purposes*

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see the Instructions for Form 1120-S. www.irs.gov/Form1120S Cat. No. 11520D **Schedule K-1 (Form 1120-S) 2021**

Form 1041, Schedule K-1, *Beneficiary's Share of Income, Deductions, Credit, etc.*

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

Schedule K-1 (Form 1041) **2021**

Department of the Treasury
Internal Revenue Service

For calendar year 2021, or tax year

beginning / / 2021 ending / /

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	**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. *www.irs.gov/Form1041* Cat. No. 11380D **Schedule K-1 (Form 1041) 2021**

Form 8865, Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-1668

Schedule K-1 (Form 8865) **2021**

For calendar year 2021, or tax year beginning ____________, 2021 ending ____________, 20___

Department of the Treasury
Internal Revenue Service

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

Part I Information About the Partnership

A1 Partnership's employer identification number

A2 Reference ID number (see instructions)

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

Part II Information About the Partner

C Partner's SSN or TIN (Do not use TIN of a disregarded entity). See instructions.

D1 Name, address, city, state, and ZIP code for partner entered in C. See instructions.

D2 ☐ If partnership interest is owned through a disregarded entity (DE), enter DE's:
TIN ____________ Name ____________

E Partner's share of profit, loss, capital, and deductions (see Partner's Instr. (Form 1065)):

	Beginning	Ending
Profit	%	%
Loss	%	%
Capital	%	%
Deductions	%	%

Check if decrease is due to sale or exchange of partnership interest . ☐

F **Partner's Capital Account Analysis**

Beginning capital account	$
Capital contributed during the year . . .	$
Current year net income (loss)	$
Other increase (decrease) (attach explanation)	$
Withdrawals & distributions	$ ( )
Ending capital account	$

G **Partner's Share of Net Unrecognized Section 704(c) Gain or (Loss)**

Beginning	$
Ending	$

For IRS Use Only

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)		
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital	16	Schedule K-3 is attached if checked . . . . ▶ ☐
4c	Total guaranteed payments	17	Alternative minimum tax (AMT) items
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		
6c	Dividend equivalents	18	Tax-exempt income and nondeductible expenses
7	Royalties		
8	Net short-term capital gain (loss)		
9a	Net long-term capital gain (loss)	19	Distributions
9b	Collectibles (28%) gain (loss)		
9c	Unrecaptured section 1250 gain	20	Other information
10	Net section 1231 gain (loss)		
11	Other income (loss)		
12	Section 179 deduction		
13	Other deductions	21	Foreign taxes paid or accrued
14	Self-employment earnings (loss)		

For Paperwork Reduction Act Notice, see Instructions for Form 8865. www.irs.gov/Form8865 Cat. No. 28396B **Schedule K-1 (Form 8865) 2021**